Direct Lending Markets in Europe and the US

Many similarities and a few nuances

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IN A NUTSHELL

- Direct lending has become an increasingly important component of global credit markets and expected to continue growing in the coming years.
- The US direct lending market is a larger and more established ecosystem, with a longer track record and greater deal flow, when compared to its European counterpart.
- In Europe, the market for direct lending offers significant growth potential, but remains fragmented and requires a strong presence and local network with private equity firms and advisors in the country where the business is located, and preferentially established partnerships with domestic commercial banks.
- The competition from liquid markets has slowed down the growth of private credit in Europe, resulting in more aggressive pricing strategies and lower expected returns, albeit still at a clear premium compared to similar risk liquid markets.
- Both regions have significant amount of capital that needs to be deployed, as the demand for deals that is anticipated to far exceed supply.
- Despite the higher interest rates and macroeconomic uncertainty, the default rates have remained low in the US and in Europe.
- ESG consideration play a central role in Europe, whereas in the US the information on the ESG attributes is collected but unlikely to be a key factor in the investment decisions at present.
- Direct lending offers financing opportunities for the European transformation, such as in the digital transformation, where small- and medium-sized enterprises play an important role.

Introduction

Europe and the United States share many foundational values that underpin the ‘Western’ way of life. However, the regions often adopt unique approaches to various topics, including the private debt market, where they are at different stages of development. This paper aims to compare the European and the US direct lending markets. To provide a comprehensive overview, we first examine the political and macroeconomic landscapes of each region, which in turn influence the distinct characteristics of their direct lending markets. Then the article explores how ESG integration varies across the two markets. Finally, we discuss the importance of direct lending for transforming European economy. This paper also emphasises that investors may want to treat two markets as complementary in the portfolio, as they offer different growth, return, ESG integration, and diversification potentials.

1 / Political environment

2024 has been tumultuous for Europe on a political level. While migration, bureaucracy and common debt discussions have seemingly been on Europe's political agenda for a decade now, only little progress can be reported on these issues. A notable exception is the Next Generation EU program, which is supposed to socialize the debt needed to stage a recovery. While the full impact of this program is still unfolding, it represents a significant step towards greater economic solidarity and resilience within the EU. In addition, the continent has been grappling with the war in Ukraine and how to deal with the political consequences of the battlefield reverberations. Despite these challenges, European nations have shown remarkable unity in their support for Ukraine, demonstrating a collective commitment to peace and stability.

All these topics have led to protests and volatile government approval ratings. Emmanual Macron saw the spiraling poll performance as a reason to call snap elections. In the aftermath of the election, he is forming a new government with a weaker mandate. However, this period of political reorganization also presents an opportunity for fresh perspectives and renewed efforts to address the pressing issues facing France. France's neighbor Germany is going through a rough patch as well. Its government is unpopular, and its traffic light coalition has lost the faith of most voters, especially in the east of Germany. Some of Germany's problems came to light during hosting the European Championship this summer when traveling fans had to face that Germany's trains do not in fact run on time anymore or patchy cellphone coverage.

While it is understandable that the EU faces challenges in making decisions on foreign policy and other issues affecting all member states, policymakers are increasingly recognizing the importance of cooperation. In a world marked by growing geopolitical divides, working together towards a more unified continent is crucial for maintaining stability and influence on the global stage.

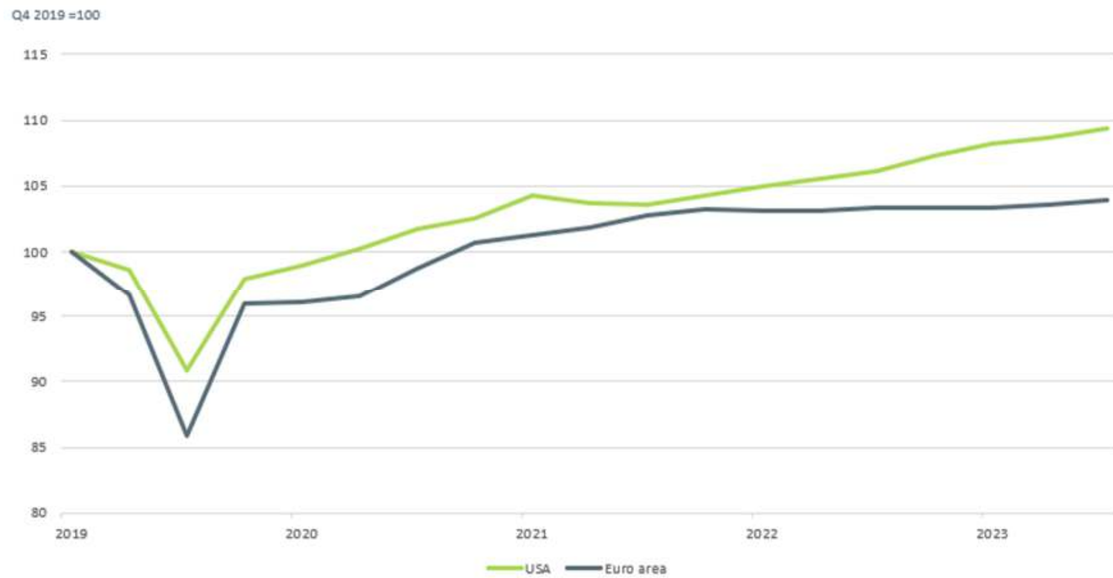
The United States has experienced its own share of political turbulence in the last few years, including just recent an attempted assassination of Donald Trump and an abrupt change in the democratic candidate for the November presidential election. In addition, the repeated political standoffs over the debt limit and last-minute resolutions have particularly contributed to concerns about fiscal governance. This resulted in Fitch Ratings downgraded the United States' long-term credit rating from AAA to AA+ in August 2023.[1] Nevertheless, the two parties have been able to find some common ground on foreign policy. For example, the Biden administration did not do a U-turn on many of the hawkish China stances the Trump presidency implemented. The outcome of the upcoming elections may be pivotal in determining how the US approaches other geopolitical issues, including its commitment to the war in Ukraine and the conflict in the Middle East. A temporary standstill in some areas of governance and foreign policy, with many key decisions and policies on hold, should be shaken of after the elections, when the direction of the new administration is more apparent.

2 / Macroeconomic view

The urgency of reinvigorating economic growth in Europe has been finally gaining the focus of European policymakers. Between 2010 and 2023, the cumulative growth rate of GDP reached 34% in the United States, compared with just 21% in the European Union and 18% in the eurozone.[2] Over the same period, labor productivity grew by 22% in the United States and 5% in the eurozone.[2] Europe's economic model has been premised on establishing an open and competitive market that benefits from free trade in a rules-based international system. Yet the return of expansive industrial policy by the United States and China, the corrosion of multilateral institutions, the focus on economic security, the slower productivity growth and ever-expanding regulations have led to significant concerns about the viability of Europe's economic approach.

[1] Fitch (August 2023). "Fitch Downgrades the United States' Long-Term Ratings to 'AA+' from 'AAA'; Outlook Stable"
[2] Polytechnique-insights (June 2024). "Economics: why Europe is falling behind the USA"

Figure 1: Stronger GDP growth in the United States compared to Euro area ("EA") (Q4 2019 = 100)



Source: Haver Analytics Inc.
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Figure 2: Higher productivity growth in the United States compared to Euro area ("EA") and Germany ("DE") (2015 – 100)

Source: Haver Analytics Inc.
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In September 2024, a former prime minister of Italy and former president of the European Central Bank, Mario Draghi presented a report on the future of European competitiveness. A 400-page document, ordered by the president of the European Commission Ursula von der Leyen, addresses three key challenges for the European Union: closing the innovation gap with the United States, harmonizing decarbonization with competitiveness, and enhancing economic security by reducing dependencies.

The report also stresses the insufficient investment in Europe, both public and private. Limited fiscal capacity following the 2008 financial crisis and lack of an integrated capital market left Europe lagging behind the United States in venture capital investment as well as in capital needed for creation of so-called "European champions"—big companies capable of competing with US and Chinese giants. According to the report, the additional annual investment at over €800 billion, or about 5% of EU GDP is needed, requiring more private resources, which in turn necessitates developing European capital markets and completing the Banking Union, along with greater public resources for joint projects funded by joint European debt.

Many of the changes suggested in the report would require the member states to accept far-reaching reforms and adopt a strong pro-European stance instead their national agenda. This can be especially challenging in this moment, with the radical right on the rise in most countries and a limited appetite for treaty changes or deeper integration.[3]

In the United States, shorter-term uncertainties are occupying many investors' minds, including the results of the upcoming elections and the period of transition when it comes to interest rate policy. A "soft-landing" is still considered to be a likely outcome. Important longer macroeconomic trends include the embrace of the industrial policy in search of national security and potential impact of artificial intelligence (AI).

The current US industrial strategy has been launched with the introduction of the Infrastructure Investment and Jobs Act (IIJA), Inflation Reduction Act (IRA), and CHIPS and Science Act that are enabling a once-in-a-generation investment in domestic manufacturing. These three pieces of legislature provide direct funding and tax incentives for public and private manufacturing construction. In 2023, US construction spending on new manufacturing facilities more than doubled compared with 2022.[4] The European Commission with the NextGen EU recovery fund, a debt-funded program worth around $880 billion, targets to match the US efforts. However, decentralized approach, in conjunction with stipulations attached to its disbursements, have made it far harder for EU companies to access funding so far.

AI is currently expected to be a major driver of innovation and productivity in the next decade. It has a potential to impact all industries and functions, creating additional economic activity linked to the increased productivity, rising consumer demand and advancements in scientific discovery.[5] Private investment now accounts for most of the investment in AI. The US is leading private investment in AI (€62.5 billion) in 2023, followed by China (€7.3 billion) and the EU and the United Kingdom (UK), which together attracted €9 billion.[6] While Europe is lagging behind on the foundation models, or large language models (LLMs) that are at the core of the generative AI, these are just one part of the gen AI landscape. Focusing on gen AI adoption, infrastructure and renewable power are necessary for the European continent to participated in the emerging economic growth linked to AI.

The European continent also needs to help companies to navigate regulation introduced by the EU AI Act. Recent McKinsey research shows that 8 of 10 European companies report that they don't fully understand the obligations introduced by the EU AI Act, and 70% find them to be complex. That confusion has consequences.[7] Meta, for example, recently stopped the rollout of its multimodal model in the EU, reportedly because of a lack of readability and predictability of the regulatory environment. Apple will also not release its Apple Intelligence in Europe at the same time as in the US.

[3] Polytechnique-insights (June 2024). "Economics: why Europe is falling behind the USA"
[4] Atlantic Council (February 2024) "The IRA and CHIPS Act are supercharging US manufacturing construction"
[5] PWC "PwC's Global Artificial Intelligence Study: Exploiting the AI Revolution"
[6] European Commission (March 2024) "AI investment: EU and global indicators"
[7] McKinsey (October 2024) "Time to place our bets: Europe's AI opportunity"

3 / Direct lending market overview

European direct lending is currently navigating a landscape marked by reduced market activity and intensified competition from liquid markets, contrasting sharply with the 'golden' years of 2022 and 2023. This shift has been driven by several factors, including macroeconomic uncertainties and more cautious investor sentiment. In this evolving environment, banks have resumed financing more deals, creating a more competitive landscape and adding a layer of complexity for private equity (PE) funds. It remains to be seen whether this represents a temporary deviation or a longer-term shift from the prevailing trend of recent years, characterized by bank retrenchment and the corresponding rise of direct lending that has been steadily gaining market share.

As participants in the market reflect on these changes, there is a palpable sense of anticipation for a more favorable macroeconomic environment. This uncertainty leaves both general partners (GPs) and limited partners (LPs) pondering when market activity will rebound. Although the current market atmosphere is quieter than in previous years, it is not entirely bleak. For instance, during the recent SuperReturn conference in Berlin, the sentiment among investors was surprisingly optimistic regarding the market outlook. Many believe that increased activity is on the horizon, particularly in 2025, and there are already indications of a slow but steady pick-up in activity observed in the second quarter of 2024.[8]

Despite improving transaction flows, the M&A market remains difficult and private equity sponsors face challenges to exit their holdings. The dislocation of the IPO market especially impacts their exit opportunities for large holdings. Furthermore, many deals do not reach conversions, as buyers and sellers fail to agree on valuation.[9] The middle market is in a better condition as the pricing pressure of the liquid markets is not as present and the exit conundrum not as demanding.

This heightened competition from liquid alternatives has led to a decline in pricing across the asset class and a corresponding erosion of structural protections, notably in the form of covenants attached to deals. Consequently, these developments have fostered a wave of skepticism towards the direct lending market, prompting some international organizations to prepare for potential downturns by developing worst-case scenario analyses. This preparation stems from the recognition that direct lending has increasingly established a significant foothold in various economies.[10] The calls for greater oversight could transform into regulatory measures aimed at enhancing transparency and tightening control in the market. Advocates of direct lending argue that it remains a relatively small fraction of the overall leveraged lending landscape across asset classes, therefore it is unlikely to threaten financial stability of the overall the financial system and the economy.

Interestingly, one segment of the direct lending market that appears to be less impacted by the downturn in pricing and the loosening of covenants is the lower mid-market. This segment continues to witness a healthy volume of activity with comparatively less competition from liquid markets, allowing it to maintain its appeal.[11] Historically, the lower mid-market has represented the largest share of the overall direct lending market. However, as the ticket sizes have grown, the mid-markets' share relative to the entire market has diminished. Despite this contraction, the overall market continues to experience growth, albeit at a slower pace compared to other segments of direct lending.[12]

US Direct Lending has been going from strength to strength and is often ahead of liquid alternatives in recent months not only financing new deals, but also refinancing deals that were previously funded from leveraged loans for example.[13] Direct Lending within US has reached about $1 trillion dollars today including $250bn of dry powder. Deployment of that capital remains a challenge though as M&A activity is subdued as the gap between seller & buyer expectations are considerably

[8] LCD (June 2024). LCD News Today, Europe: June 4, 2024
[9] Pitchbook (May 2024). "Europe's direct lenders respond to bank challenge, patchy M&A outlook"
[10] LCD (April 2024). "IMF ponders private credit nightmare scenario, calls for transparency"
[11] Pitchbook (May 2024). "Europe's direct lenders respond to bank challenge, patchy M&A outlook"
[12] Cambridge Associates (April 2024). "Private Credit Markets Are Growing in Size and Opportunity"

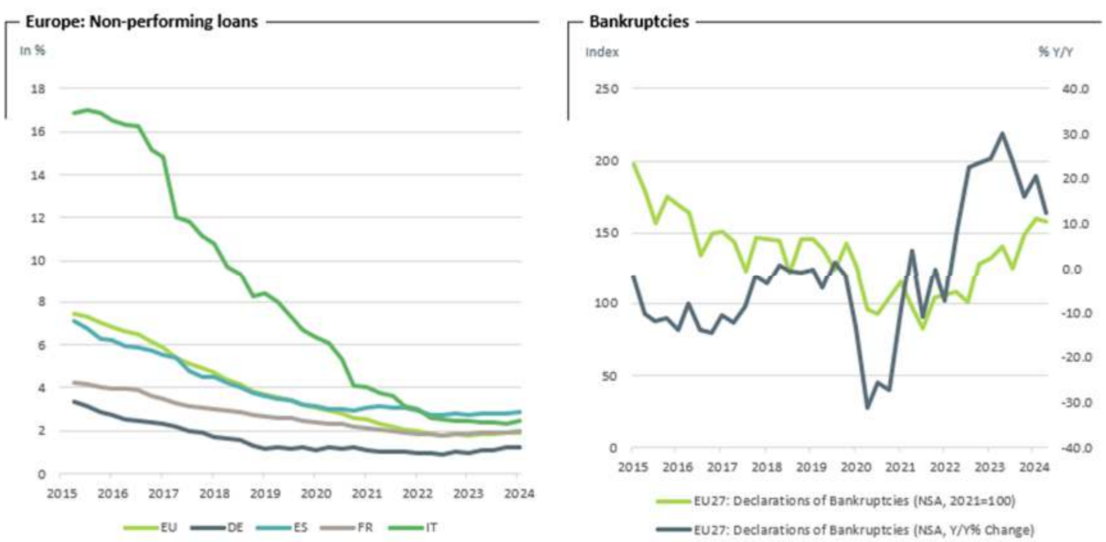
[13]LCD (September 2024). "Private credit shapeshifts in Q3, in reaction to BSL market, Pluralsight"

apart in most cases. Therefore, in that respect the market is encountering the same problem as the European market mentioned above. With rate cuts, this predicament has the chance to change. Just like Direct Lenders, PE entities have capital to deploy and are under pressure to return to some to their own investors. For the US Direct Lending market retail interest is growing with at least 3 ETFs being launched/announced dedicated to Private Credit or PC CLOs.[14] One trend in the market, that is also shared across the pond is the increase in PIK payments and with lower interest rates expected in the coming months, it is gaining in popularity.[15] This allows companies to preserve their cash reserves and Direct Lenders have pounced on the chance to make their deals more attractive through PIK payments.

Overall, the US direct lending market is a larger and more established ecosystem, with greater deal flow and a longer track record, when compared to its European counterpart. Following the global financial crisis (GFC) in the United States, there was a large number of cycle-tested investment professionals moving from sell-side leveraged finance groups to buy-side private credit firms.[16] This did not happen in Europe, as banks have retained market share, and therefore managers have shorter average tenures. The US has a more uniform structure and homogenous regulatory environment which facilitates opportunities across the space for private credit lenders. In contrast, the European direct lending market is more complex to navigate due to fragmented legal jurisdictions, thus local presence and expertise in the target markets is paramount. The sponsor-lender dynamic is similar in Europe and the US, with the core middle market being direct relationships-based, with constructive structures and solutions.[17]

In terms of defaults, the two regions have comparable figures. In Europe, there is a steady decline in defaults ever since the announcement of a European banking union in 2012-2014, Figure 4. However, due to the missing deposit insurance scheme for banks, the banking union is not complete, and a capital market union is still in the far distance for the European Union. The north-south divide in terms of defaults is still noticeable. Arguably, the US market, due to its size and maturity, is more commoditized and fewer tailor-made covenants are in place. However, as evident by the numbers of non-performing loans this does not necessarily translate into higher delinquencies, Figure 5.

Figure 4: Non-performing loans and bankruptcies in Europe

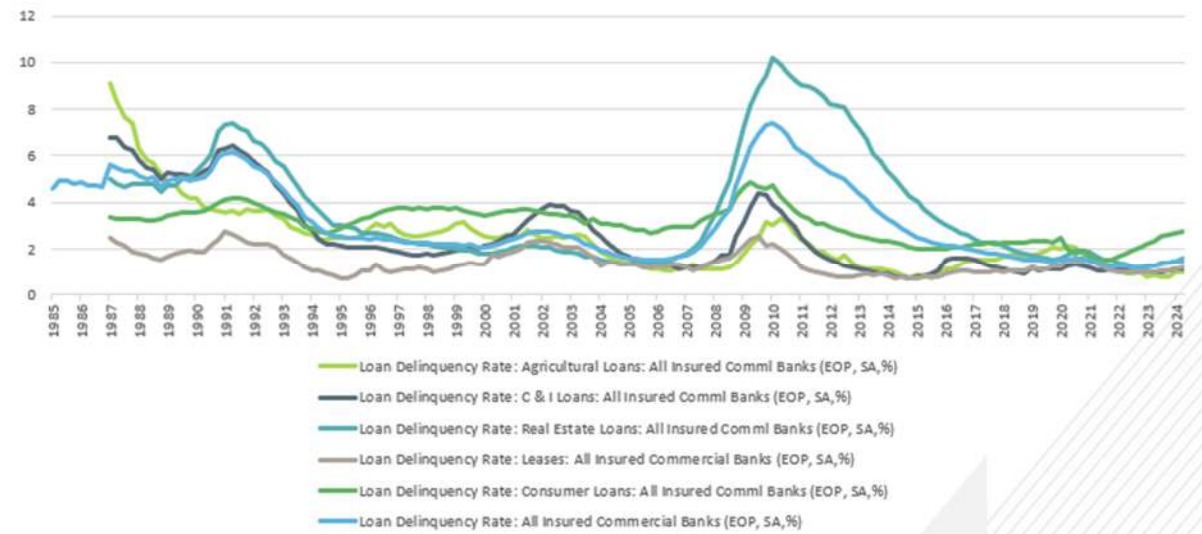


Source: Haver Analytics Inc.

This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Past performance is not indicative of future returns. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect.

[14] Bank of America (September 2024). "Private Credit – Evolution into a lower rate environment – CLOs and opportunity set"
[15] LCD (October 2024). "Private credit PIK portion rises, allowing borrowers to preserve cash"
[16] Man Institute (June 2024). "Transatlantic Pathways: Charting the Course of Direct Lending in the United States and Europe"
[17] S&P Global (November 2023). "Credit FAQ: How Private Credit's European Expansion Brings Rewards And Risks"

Figure 5: Delinquency rates in the United States



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The European market offers abundance of growth potential compared to its more mature American peer. Presently, the returns have been generally more attractive for the US market, including due to differences in base rates and the dollar strength. Finally, in the US, retail investors have received access to participation in private markets through business development companies earlier compared to Europe, where the efforts to establish retail vehicles are still nascent.[18] Greater European retail participation can be driven by the growth of European Long Term Investment Funds (ELTIF), established in 2015. The ELTIF provides an accessible, retail-friendly structure allowing individuals to benefit from the same private market opportunities previously accessible only for institutional investors. We believe that investors may want to treat two markets as complementary in the portfolio, as they offer different growth, return and diversification potentials.

A particularly interesting part of the direct lending space for both European and the US markets is 'sponsor-less' transactions. In sponsored direct lending, the private equity (PE) sponsor had the primary relationship with the company, and private credit investors provided leverage to the sponsor. In contrast, in sponsor-less direct lending, the lender has the primary relationship with a company, without the involvement of a private equity sponsor.

In the broad debt market, sponsor-less transactions represent a smaller part of overall lending compared to sponsored transactions. However, by including sponsor-less transactions, direct lending investors can significantly expand investment universe, offering greater selectivity and attractive return potential as these deals are often priced at a premium. Another important feature is that sponsor-less transactions are by nature 'less intermediated'. In many cases, this means stronger loan documentation as well as better financial conditions and higher target internal rates of return (IRR) for investors. For instance, sponsor-less transactions can be less competitive as the extra legwork in the due diligence and added risk without a sponsor make it a less likely to encounter a crowded auction processes, in which multiple potential lenders compete by offering lower margins and more borrower-friendly terms.[19]

[18] DWS Investment GmbH, internal research, September 2024

[19] DWS Investment GmbH, internal research, October 2024

4 / ESG and sustainability integration

ESG and sustainability-related information are becoming a more important part of the due diligence process for private debt and specifically for direct lending investments. While integrating ESG factors into direct lending can be more challenging than in other asset classes, there is a growing belief that companies with good or improving ESG practices have lower overall risk.

While the private debt firms in the US have been making progress in terms of ESG integration and disclosure, Europe is likely to retain the advantage. In 2022, 50% of European leveraged loans included sustainability-linked features, up from 44% in 2021.[20] US fund managers can benefit from Europe's experience by adopting disciplined and transparent ESG reporting practices. This includes being able to clearly explain how ESG factors are integrated into investment strategies and using templates that allow to collect data in a consistent manner.

In certain instances, ESG metrics are becoming embedded into the life cycle of the loan. From a lending perspective, this has initially taken the form of ESG negative screens, prohibiting lending to certain sectors or activities. More recently, this is being extended into defining certain sustainability thresholds or targets that the company should achieve.

Direct lending via Sustainability Linked Loans (SLLs) can incentivize companies to promote sustainability in a borrowers' business operations. This can be achieved by linking the borrowing costs of the loan to either an ESG rating target for the borrower or identifying ESG-related key performance indicators (KPIs) with pre-defined Sustainability Performance Targets (SPTs). These two approaches can have their advantages since a third-party ESG rating may recognize that the borrower may not have the internal resources available to report and monitor on specific ESG-related KPIs. Alternatively, where specific KPIs are selected these can be tailored to the individual borrower and its operational objectives.

Issuance in SLLs witnessed significant growth reaching just over US$500 billion by 2021. This was led by the Americas followed by EMEA, which combined represented approximately 90% of the global SLL market. However, since this peak, issuance has cooled significantly, Figure 6. In 2024, $207 billion has been lent through SLLs in the first half of 2024 – a decrease of around 34% year-on-year.[21]

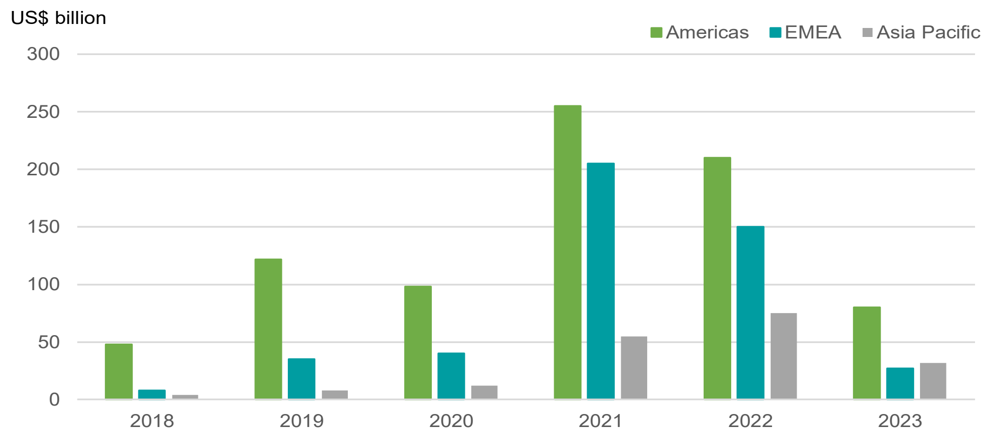
There are many reasons for this overall market contraction. Firstly, all sustainable loan instruments have been negatively impacted by a high interest rate environment and geopolitical tensions. For the SLLs, in particular, lower popularity can be attributed to regulatory and reputational risks arising from 'greenwashing' concerns and often prohibitive costs associated with developing and externally verifying of sustainability metrics and targets. Another factor may be the prevalence of amend and extend (A&E) loans which typically recycle the terms of the existing debt.

Efforts to address some of the shortcomings of SLLs are already underway. For example, the introduction of standardized industry templates may help to simplify ESG data collection as well as reduce the wide dispersion of data quality which exists by sector. This was revealed in a survey conducted by the PRI last year,[22] which revealed that the quality of ESG datasets in the energy sectors outperform other sectors by a significant margin.

Energy and environment themes have dominated in 2023 and earlier in 2024. Over one third of use-of-proceeds deals are used to fund renewable energy projects, accounting for more than 62% by volume. This is followed by other use-of-proceeds categories such as green buildings, clean transportation, energy efficiency, and eco-efficient products.[23]

[20] Private Debt Investor (July 2023). "ESG's battle to stay in the spotlight"
[21] Environmental Finance (2024). "Sustainable Loans Insights 2024"
[22] PRI (September 2023). ESG incorporation in direct lending https://www.unpri.org/private-debt/esg-incorporation-in-direct-lending-a-guide-for-private-debt-investors/11772.article
[23] Environmental Finance (2024) "Sustainable Loans Insights 2024"

Figure 6: Size of the global sustainability-linked loan market by region



Source: Bloomberg Finance LP (annual data, 2023 data up to November 2023).

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5 / Opportunities for European transformation

In our previous research,[24] we highlighted that direct lending is an important financing solution for transforming European economy in the decade ahead. Small and medium-sized enterprises (SMEs) which are the backbone of Europe's economy have no direct access to capital markets or other sources beyond credit. Direct lending can support technological change and improve the competitiveness of SMEs of all sizes and across all sectors and geographies.

Our definition of European transformation encompasses a large number of themes across various sectors and economic activities, in which SMEs play a crucial role, Figure 7. These themes are often interconnected and can influence and reinforce each other. A great example of this is the sustainability and digitisation. The European Commission continues to highlight the importance of twinning the green and digital transition.[25]

European direct lending has had a record of sectoral focus, with most deals taking place in healthcare, technology and business services. However, a recent decline in available opportunities is prompting some direct lender to cautiously explore a broader range of sectors. Expanding the deployment of direct lending finance to a broader range of industries and themes will help European SMEs with strong business concepts to further grow and/or improve their profitability, while making the European economy more competitive overall. In contrast to the needed expansion of sectors benefiting from direct lending, geographical diversification has been growing. Regions such as Benelux and the Nordics are catching up with the traditional direct lending core markets of the UK, France, and Germany, opening opportunities for SMEs across many countries to benefit from private debt financing.

[24] DWS, Direct lending & the European transformation, 2023. https://www.dws.com/en-us/insights/dws-research-institute/direct-lending-and-the-european-transformation/

[25] European Commission (2022). Strategic Foresight Report 2022

Figure 7: European transformation themes

Source: DWS International GmbH, as of September 2024.

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To finance European transformation, it is also important to note the importance of sponsor-less deals. Currently, more than 80% of European direct lending assets are concentrated on sponsored companies, Figure 8.[26],[27]Lacking a private equity sponsor, sponsor-less transactions are generally less leveraged and more flexible on terms. Without the M&A component, they instead support an SME's organic growth, innovation projects or capital expenditure. Critically, without a private equity sponsor, the fund managers can work directly with the company to negotiate terms, impose covenants, and enhance risk-adjusted returns.

Figure 8: Sponsor backed versus private deals as % of total deals per quarter

Source: Deloitte (2024) "The Private Debt Deal Tracker Spring 2024".

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[26] European Investment Fund (EIF) (November 2019). "Breathing life into 'sponsor-less' transactions"

[27] Deloitte (2024) "The Private Debt Deal Tracker Spring 2024"

Sponsor-less transactions therefore represent a big opportunity for investors to select high-quality SMEs, diversify their risk and de-correlate from sponsored deals, to exercise hands-on investment monitoring and enhance risk-adjusted returns compared to sponsored transactions. Expanding the deployment of direct lending finance to non-sponsored lower middle market transactions will help European SMEs with strong business concepts to further grow and/or improve their profitability, while making the European economy more competitive overall.

6 / Conclusions

Direct Lending has found its role in the private credit sector and is likely to expand it further in coming years. The demand from companies that cannot or do not want to finance themselves in the public market and prefer not to rely on bank credit is growing steadily. For investors, the segment has established itself as an attractive asset class, which has demonstrated risk adjusted outperformance, especially compared to fixed income.

In coming years, we see the European Direct Lending segment getting closer to its U.S. counterpart, although this process will likely take more than a couple of years. We believe that investors may want to treat two markets as complementary in the portfolio, as they offer different growth, return, ESG integration, and diversification potentials.

The US market for private debt, including direct lending is expected to continue to grow and attract larger companies. In Europe, much will depend on how strongly banks cling to their role in the credit market and how aggressively direct lending providers fight to increase their share. A recovering economy and the ambitions for European continent to reinvigorate its growth and gain back its competitiveness on the world arena should contribute to rising demand for loans as the willingness to invest grows.

Important information – EMEA, APAC, LATAM & MENA

as of 10/28/24; 103359-1 (10/2024)