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Press Release

Credit Market Update: 'Despite Lingering Market Questions, Senior Credit Is a Bright Spot for Investors'

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London, 14 August 2024 – Globally, geopolitics, interest rates, and the role of AI have collectively created ongoing uncertainty in the market. Yet, **European leveraged finance markets have maintained a bright spot for investors.**

Despite the uncertainty, while below 2021 levels, M&A activity has increased in both the public and private markets, posting the highest quarterly LBO volume since 2022. All considered, **we believe that flexibility is a key advantage today when investing in senior private credit.**

While the S&P 500 looked to maintain its upwards trajectory on the strength of the Magnificent Seven through the second quarter, momentum slowed through July, before weak US jobs data sparked volatility not seen in nearly two years. While there was some weakness in the crossover market in line with the equity moves the European leveraged finance markets have been relatively sheltered to date from this broader macro uncertainty, as a healthy pipeline of CLO new issuance and fund inflows have created strong technical demand for both loans and bonds.

Politics, Rates & AI: Weathering the Uncertainty

Heading into 2024, markets across the globe had priced in expectations for near-term rate cuts. The Fed had priced in rate cuts as early as this past March, which were quickly diminished by a hotter than expected CPI release, creating headwinds for fixed rate assets.

While the S&P 500 continued to post gains during the second quarter, this continued strength was driven by the Magnificent Seven, and enthusiasm started to fade through July. The implication that not all companies will benefit from AI equally is clear. For instance, loans backing outsourced customer services provider Sitel sold off after fintech company Klarna announced that that the company's AI assistant now handles the work of 700 customer services reps.

With around 1.5 billion people heading to the polls in 2024, elections were always certain to be a factor that could blow markets off course during the year. While the Labour Party's landslide victory in the UK was broadly expected, for European leveraged finance investors, it was an election no one was expecting that created the biggest waves. Following a disappointing result for his coalition during the European elections, President Macron's decision to call a snap election finally paused the loan markets continued rise. France was no exception to the big political swings common in many of the elections this year, with populist parties on both ends of the political spectrum gaining support. Macron's gamble appears for now to have paid off, with no faction currently able to form a ruling majority the potential for more disruptive economic policies seems more limited.

The French market has been a strong source of deal supply for traditional mid-market direct lenders in recent years, and the ongoing political uncertainty is likely to diminish appetite for deal making in the near term. Now, the US election cycle has taken the centre stage, having not been short of headlines to date, we expect this may be a source of further uncertainty in the months to come.

New Loan Issuance Continues to Rebound

Activity in the European Syndicated Loan market was in full swing during the second quarter, boosted by the strong technical bid from CLOs. As a result, new institutional issuance in the first half of 2024 totalled €48.6 billion, over 3.7x the volume seen during the same period in 2023[1].This new issuance though was dominated by opportunistic deals and dividend recapitalisations while M&A related issuance still remains far lower than the levels seen in 2021.

M&A activity in the first half of the year has remained limited, therefore a strong technical bid from ramping CLOs can lead to more marginal credits coming to market or see documentary protections slip as investors rush to deploy capital. **It is important to remain disciplined, ensuring investors are adequately compensated for the risk taken**.

Some headline metrics might seem to suggest markets are dismissing the pressures that higher rates, geopolitical uncertainty and inflation have created for issuers. However, there are continued divisions in how the market is performing. Issuers with balance sheets which are no longer sustainable in a higher interest rate environment or are in industries facing structural challenges, such as real estate, are still trading at elevated spreads. Dispersion has remained elevated and has not followed the historical pattern of declining alongside index spreads.

M&A Activity: Showing Signs of Life

The question market participants are all grappling with though is when will the starting gun sound on broader M&A activity. **The pressure on Sponsors to resume deal making has certainly not faded away.** Half of all companies held in global buyout funds have been held for at least four years[2], while private equity dry powder in Europe sits at $422 billion[3], twice the level seen during the GFC. The busy calendar of new issuance and opportunistic transactions clearly show that the leveraged finance markets are receptive to new issuance, and certainty of financing is no longer a limiting factor, deal making activity still remains muted.

A boom in deal making during the summer months seems unlikely. According to a Bain & Company survey of 1400 market participants[4], close to 40% of respondents predicted activity won't increase until 2025 or beyond. When asked what the primary reason for slow exit activity was, the survey

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[1] Source: LCD Global Interactive Loan Volume Report as of 30 June 2024
[2] Source: Pitchbook as of 30 June 2024
[3] Source: Preqin Pro, 03 May 2024. Private Equity has been defined as the combined total of the following Preqin categories: Buyout, Venture (General), Growth, Early Stage, Early Stage: Seed, Early Stage: Start-up, Secondaries, Expansion/Late Stage, Balanced, Turnaround, Hybrid and PIPE
[4] Source: Bain & Company Private Equity Midyear Report

noted general deal malaise due to uncertainty and continued debate over valuations as the main hurdles to increased deal activity.

While Sponsors may not believe it is the optimal time to exit a portfolio company today, there has been a clear trend of using the strength of the credit market to position capital structures in a way that will best facilitate a future sale. A common feature in a number of deals this year has been leverage-based portability features, which provide certainty of funding for a potential acquirer, helping to mitigate the risk that there is a return to the uncertainty that dominated credit markets over the past few years, and positioning a company well for a near term sale.

Identifying the Sweet Spot in Senior Private Credit

It is not only in the public market that we have seen signs that the M&A cycle is about to pick up. As market volatility effectively shut the syndicated market to all but the strongest issuers through 2022 and the first half of 2023, the private credit market remained resilient attracting ever larger issuers to the market. While we have seen some of these deals now refinance back into the public market, commentary suggesting that private credit may now be taking second place on the podium to public credit markets is, in our opinion, overblown. **The flexibility that private credit can offer, through features such as delayed draws, continues to appeal to Sponsors** and the proportion of deals backing new buyout deals in Europe in the first half of the year has increased versus the same time last year[5].

We believe that flexibility is a key advantage today when investing in senior private credit. A manager who has the experience and expertise to underwrite large cap opportunities, as either a sole lender or as part of a club deal, alongside providing capital for €40m EBITDA companies that lack the scale needed for either a public market transaction or to attract the interest of the largest global private credit funds, is well placed to source opportunities with attractive risk return profiles. We are seeing more activity from traditionally large cap focused Sponsors in companies in the €40-100m EBITDA range. In a higher interest rate environment Sponsors cannot simply rely on multiple expansion to generate returns and instead need to focus on opportunities where they can improve margins, such as through buy and build strategies. With likely cap stacks in the sub €400m range, the private credit market is a more natural fit for these transactions than the broader syndicated market where smaller transactions are unfavoured by market participants given their likely low liquidity. This trend is creating opportunities for managers such as AlbaCore who have strong existing relationships with these Sponsors and can be flexible across the EBITDA spectrum.

As the summer months end, we expect that the pipeline of opportunities in the senior private debt market will increase as deal activity picks up.

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[5] Source: Reorg as of 16th July 2024

David Allen is the Managing Partner and Chief Investment Officer at AlbaCore Capital Group.

Mr. Allen has more than 30 years of financial services and investment experience, with a focus on the High Yield and Leveraged Finance Markets.

Prior to founding AlbaCore Capital Group, Mr. Allen managed Canada Pension Plan Investment Board's European Principal Credit Fund and was a member of the Investment Committee. Mr. Allen was also a Partner, Investment Committee member and Senior Portfolio Manager at GoldenTree Asset Management, where he established and ran the firm's European presence. Mr. Allen spent a decade with Morgan Stanley in New York and Hong Kong, working across M&A and investment banking before specializing as a High Yield media analyst.

Mr. Allen graduated from the University of California, Berkeley, where he earned a Bachelor of Arts in Economics and was an all-conference rower.

About AlbaCore Capital Group

AlbaCore Capital Group is one of Europe's leading alternative credit specialists, investing in private capital solutions, opportunistic and dislocated credit, CLOs, and structured products. Founded in 2016, AlbaCore is part of the First Sentier Investors Group. AlbaCore's investment philosophy is focused on capital preservation and generating attractive risk adjusted returns through the cycle for its investors. AlbaCore manages US$ 9.4 billion in AuM[6] as of 30 June 2024 on behalf of global pension funds, sovereign wealth funds, consultants, insurance companies, family offices and endowments around the world.

For more information, visit www.AlbaCoreCapitalGroup.com

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[6] AuM is calculated as the sum of the Net Asset Value, undrawn capital commitments, available debt finance and assets of all vehicles managed by AlbaCore.