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Why Europe?

Market Considerations for Private Credit

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Introduction

A major theme within global finance over the past 15 years has been the migration of leveraged lending away from banks and towards private debt funds.

“Characteristics attracting investors to the private credit market include low-volatility risk-adjusted returns with a substantial cash component and, yields boosted by a higher-rate environment.”

Tim Flynn

This theme was initially most relevant for mid-market companies but has grown increasingly important for upper-mid market and large-cap borrowers as well.

Rather than progressing linearly, that process has tended to accelerate during periods of market volatility. In the latest such example, beginning with the surge in inflation and resulting global rate hiking cycle in late 2021, we saw dislocation in a number of areas that enabled private credit to take further share in new parts of the lending market. In 2022 and early 2023, banks' 'risk-off' appetite towards new underwrites subdued the 'traditional' supply of lending, while a slowdown in CLO issuance deprived leveraged loan markets of their biggest buyers.

Despite a partial recovery in markets in 2023 that checked some of the gains made in the preceding period, the year was still heralded by many industry participants as a 'golden age of private credit'. Institutional allocators have sought to increase their exposure to the asset class, with the $1.5tn in global private debt AUM as of 2022 forecast to grow by 11% per year (Preqin). Characteristics attracting investors include low-volatility risk-adjusted returns, a substantial cash yield component to the return (allowing investors to meet the demands of their stakeholders or redeploy capital as they see fit) and as a floating-rate product, it acts as a natural hedge in a higher interest rate environment.

In our view this forecast increase in the supply of capital and in the number of fund managers establishing private credit strategies can be easily absorbed by demand from the borrower side. This is in part due to record levels of private equity dry powder ($2.6tn, per Preqin), creating a ready source of deal flow for non-bank lenders. It is also attributable in part to the improved understanding, appreciation and acceptance among borrowers (both sponsor- and non-sponsor-backed, as well as both mid-market and large corporates) of the benefits of the private credit product compared to more traditional sources of financing.

Even as the syndicated markets continue their recovery through 2024 and beyond, private credit is likely to retain its enlarged role as an established and complementary component of the financing landscape for mid-market, upper-mid-market and large corporate borrowers. The question that many LPs are therefore asking themselves is how to optimise their exposure to this asset class, where both the supply of and demand for capital is rapidly evolving, in order to generate the most attractive risk-adjusted returns for their clients and beneficiaries.

While North America is the largest, most liquid and longest-established private credit market, we believe that a flexible mandate with a sizable allocation to Europe offers the most compelling opportunity. That assessment is based on both long-term trends and what we are seeing on the ground today.

Why Europe?

Our main reasons for this view, outlined in greater detail in this paper, are:

Europe remains a more bank-centric market with less sophisticated capital markets than the US, meaning it remains ripe for further disruption by private credit.

Europe's implementation of recent regulatory and banking supervisory standards presents an additional opportunity for private credit to gain additional market share.

An established local presence across Europe provides access to differentiated deal flow where the competitive dynamics are more in the lender's favour.

The perception of the US as a more creditor-friendly jurisdiction than certain Western European markets is an oversimplification, with recovery rates in Europe historically being higher than in the US.

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1.

Europe: a bank-centric market ripe for disruption

The origins of private credit as an asset class

In Europe, the central thesis supporting private credit's long-term growth prospects, and its appeal as an asset class, revolves around the disintermediation (and, in certain circumstances, replacement) of banks in the lending ecosystem.

Since the global financial crisis, increasingly intensive regulation of the banking sector (beginning with Basel II, followed by Basel III and now with the implementation of Basel IV in 2023) has prompted banks to scale back their leveraged lending activities. Specifically, banks have focused on large corporates at the expense of medium-sized businesses, which incur more expensive capital charges. Economic and political pressure compounded banks' aversion to providing higher-risk leveraged finance solutions to middle-market borrowers, outside of crisis periods such as COVID-19.

"Europe remains a meaningfully more bank-centric market than the US, providing opportunity for further retrenchment in the sector."

Marc Chowrimootoo

In order to address this funding gap, investment managers raised closed-ended funds from institutional allocators. These were used to extend loans to those mid-sized corporate borrowers who were no longer being served by their traditional lending partners, the banks.

This has become a commonly cited and widely understood explanation for the emergence and proliferation of private credit funds in the past 15 years. The opportunity set for private credit is defined, in part, in opposition to the lending appetite of the banking sector. How the disintermediation of banks plays out further in the coming years will therefore inform the future evolution of private credit, as well as the returns on offer.

Europe's banks still have further to retrench

Europe remains a meaningfully more bank-centric market than the US.

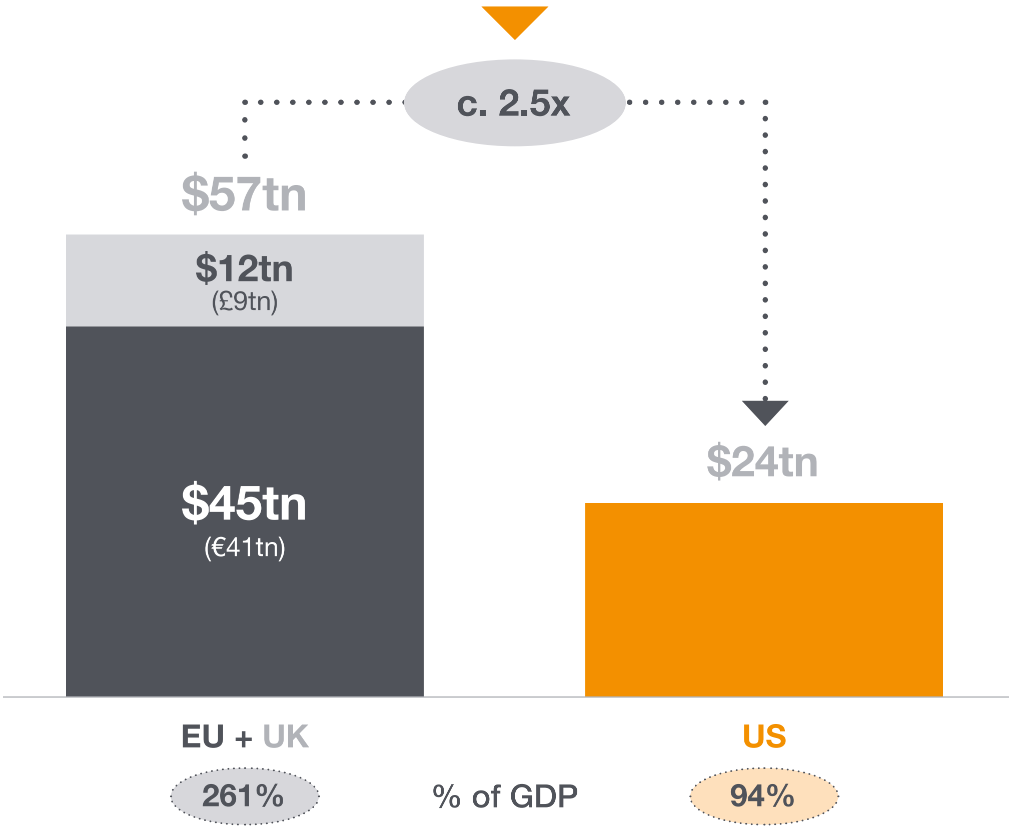
The total assets held by European banks are >2x larger than their US counterparties ($57tn vs. $24tn respectively), despite US GDP being 1.8x Europe's ($27tn vs. $17tn respectively).

European banking assets represent a far higher % of GDP than the US

USD Trillion; Bank Assets under FED / ECB / BOE supervision[(1) (2)]

Sources:
EBA, FDIC, FRED St. Louis, EBF (European Banking Federation), BoE

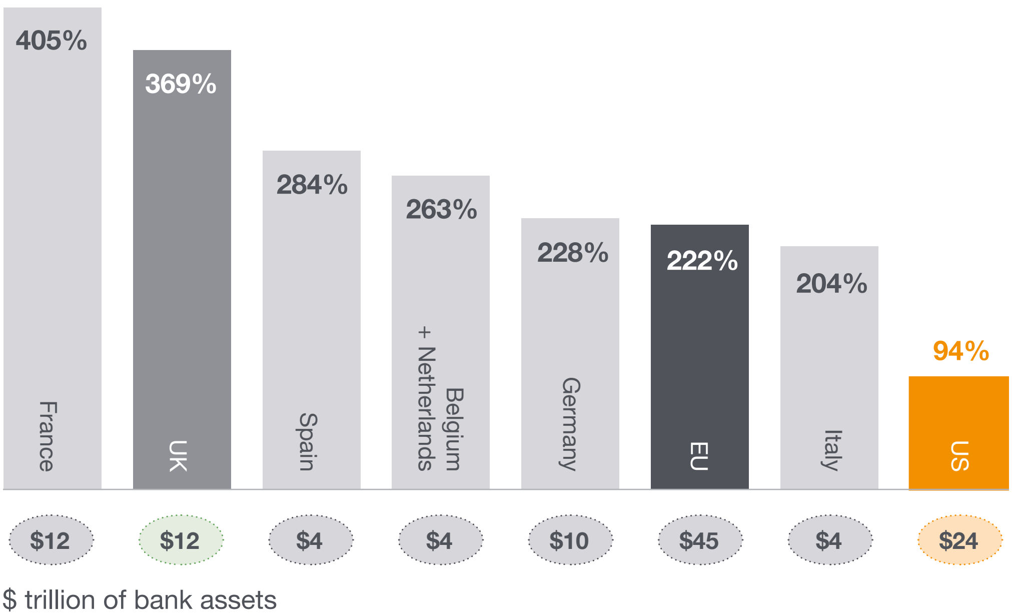
Notes:
(1) US: The FRED of St. Louis covers 4,681 commercial US banks; EU: EBA / ECB cover the largest 122 banks + 2,089 additional "less significant institutions" For Europe, the remaining 3,052 smaller banks are not supervised by the ECB due to their smaller size but they are regulated by their states (source: EBF; 2009 data for 2007 chart); (2) Exchange rate applied: 1.10 for EUR / USD and 1.25 for GBP / USD



The main European regions have a higher "Bank Assets to GDP" ratio than the US

%; 2023 Bank Assets to GDP by country

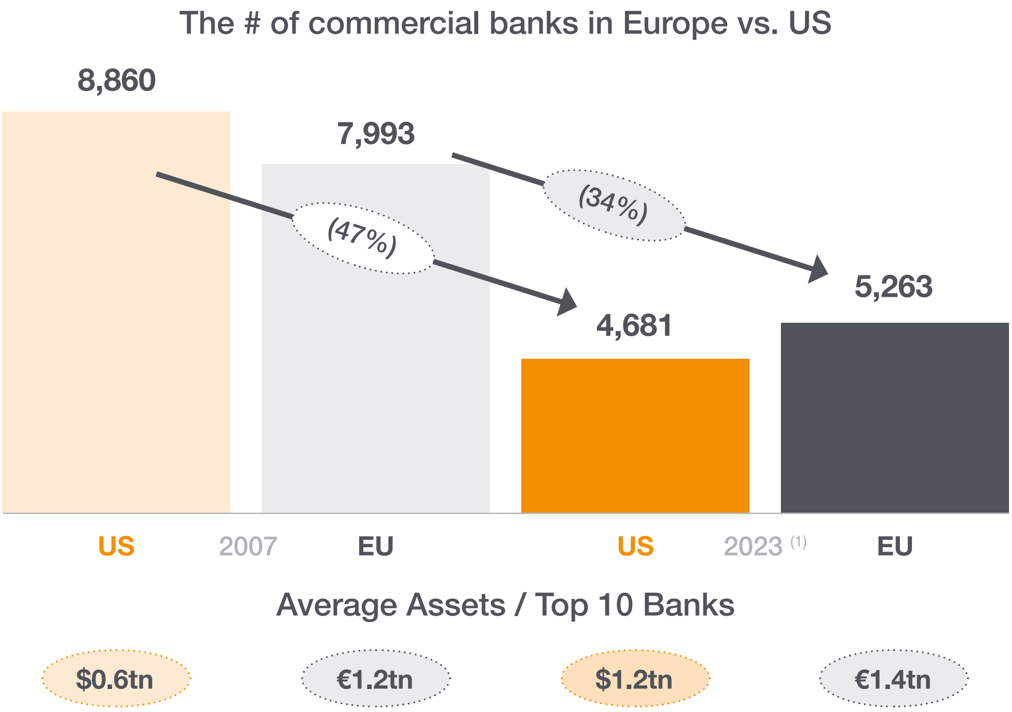
Sources:
FDIC and Fred St. Louis



Why Europe?

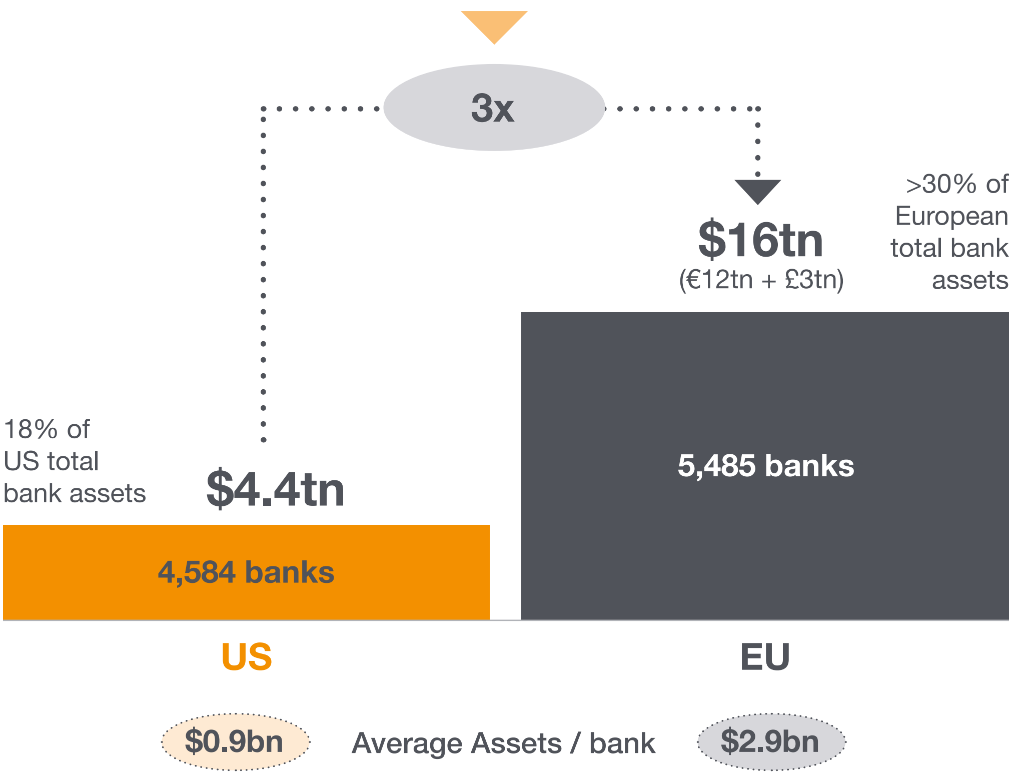
While in the past 16 years there has been a secular decline in bank lending as a proportion of total economic activity in Europe, with EU member states' bank-assets-to-GDP ratio falling from 295% in 2007 to 222% in 2023, in the US, the equivalent bank-assets-to-GDP ratio is less than half, at 94%. The UK, while significantly lower than the EU, is also materially higher than the US, at 119%. As a corollary, 85% of corporate debt financing in Europe is provided by banks, compared to 50-55% in the US.

Bank consolidation post the GFC: US Top 10 banks have increased in size (vs. Europe flat) and hold 52% of total assets (vs. 39% in EU)



Assets held by "tail banks" in Europe are 3x vs. the US; "Tail-banks" are more vulnerable to shocks and consolidation

$ trillion; Assets held by commercial banks with <$20bn in assets



Sources:
EBA, FDIC, FRED St. Louis, EBF

Notes:
(1) European banks as of Dec-21;
US banks as of Mar-23

Why Europe?

The European banking sector is also more fragmented than the US, despite consolidation following the Global Financial Crisis (GFC). In the US, consolidation of the banking sector started in the late 1980s. In Europe, it only began in earnest after 2008, lagging behind due to the greater importance of local banks and fragmented regulation hindering cross-border mergers. As a result, the biggest 10 banks in the US account for 52% of total assets; in Europe, the equivalent metric is 39%. Additionally, the tail end in Europe is much longer and hence more vulnerable to shocks. There are more than 5,000 extra-small EU banks (with <$20bn of AUM), holding >30% ($13tn) of total EU banking assets; this compares with 18% ($4tn) for the same peer group in the US.

Europe's less developed liquid credit market

The retrenchment of commercial bank lending activity can also be seen in the emergence of the liquid institutional credit market in both the US and Europe. Akin to private credit, this occurred significantly earlier in the US,

from the 1980s onwards, vs. Europe as can be seen by the fact that US public debt markets are almost five times the size of Europe's ($3tn vs. $660bn).

This difference in size and maturity profile has important implications for the provision of credit via this channel in Europe. Given it is a shallower pool of capital, during market stress the European market experiences higher volatility and more sustained periods of shutdown (for example, during the GFC, Eurozone crisis of 2011-2013, and following Russia's invasion of Ukraine in early 2022) vs. the US market which tends to reprice instead. This higher volatility also leads to investment banks periodically exiting the market, often prematurely, which can further constrain credit provision.

There are also trends emerging amongst the borrower base that constitute the European public markets that present an opportunity for private credit funds. They have become more difficult for smaller companies to access. Loans of less than €250m have become much more uncommon in Europe, accounting for 5-10% of total deals today vs. >80% pre-2008 and, notably, a lower proportion than the 20-25% of share in the US, despite the US market's larger average issuer size. This, combined with a focus on 'vanilla' sectors, organic growth focused businesses, and mature management teams more conversant in English serves to broaden the scope of private credit's addressable market in Europe.

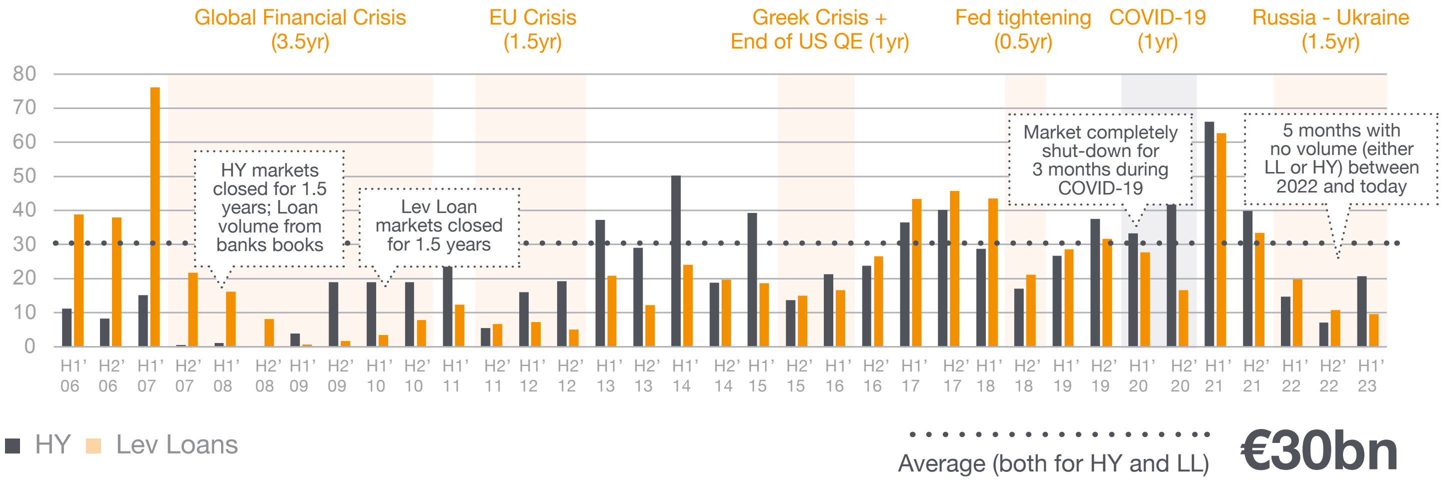
Altogether, it's clear that as and when banks do pull back from more of their traditional lending activities, European public markets are less equipped to reliably pick up the slack, particularly for smaller borrowers, leaving the door open for private credit funds to take advantage of this opportunity.

Why Europe?

European High Yield and Leveraged Loans issuance, 2006-2023 (€ bn)

Muted market windows highlighted in orange (+ length in years)

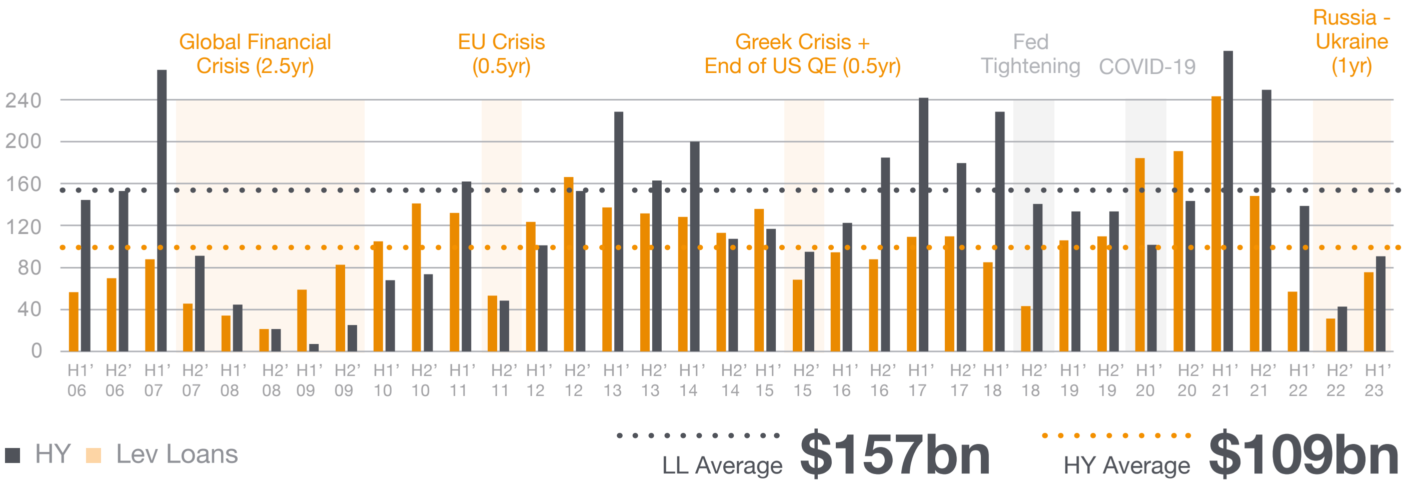
Source: Pitchbook



US High Yield and Leveraged Loans issuance, 2006-2023 ($ bn)

Muted market windows highlighted in orange (+ length in years)

Source: Pitchbook

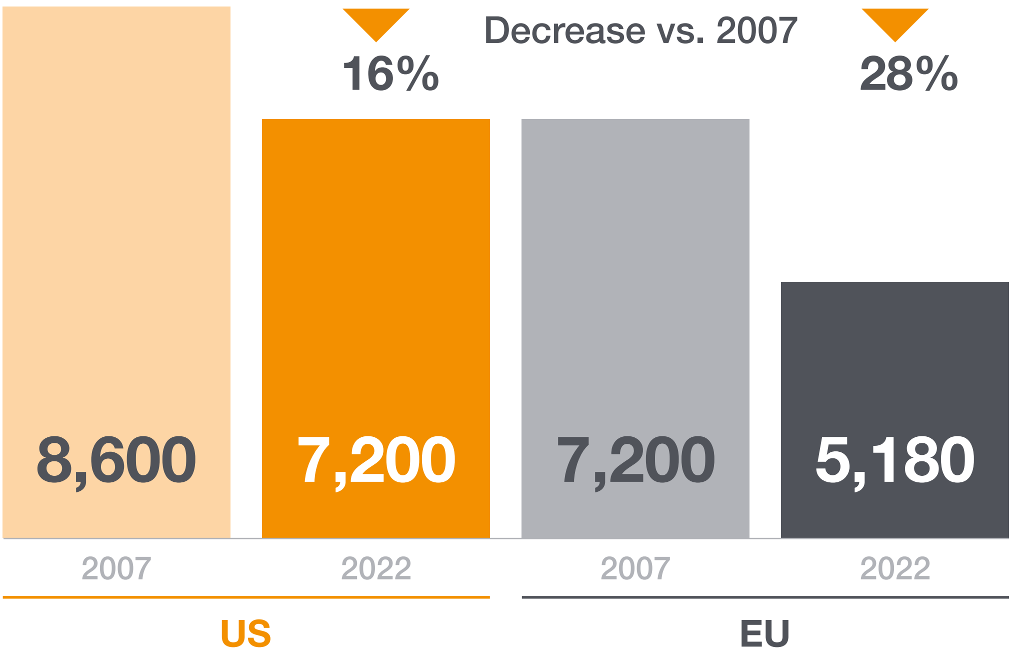


Why Europe?

Corporates are shifting away from public debt markets, especially in Europe as they are less developed and are fragmented across regions

# of distinct HY + Leveraged Loan issuers in Europe and the US

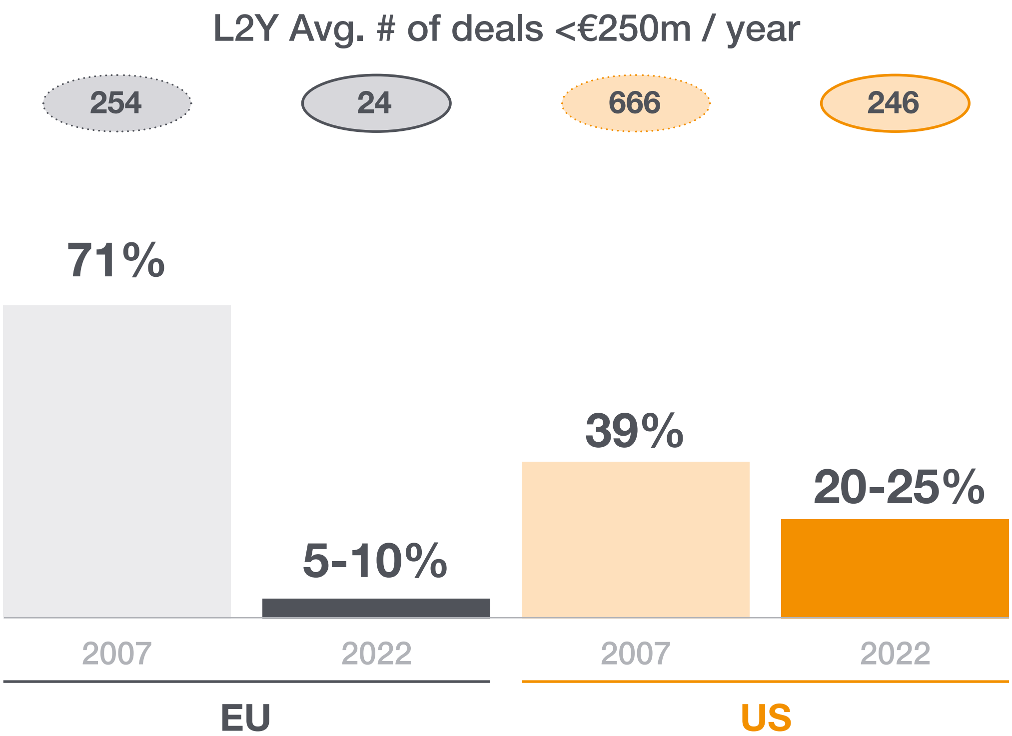
Sources:
Dealogic, LCD, JPM Research



Public markets are shifting towards large borrowers Companies with <€250m issuance (+5x leverage)

% of tranches <€50m ($300m equivalent for the US); based on deal count

Sources:
Dealogic, LCD, JPM Research



Why Europe?

The growth of European private credit to date

The European private credit market provides a solution. With an average debt quantum of €240m for private debt deals and average EBITDA of €25m, private credit covers practically the full spectrum of deal sizes. Approximately 30% of deals are bigger than €100m (55% in 2020), c. 25% of deals are greater than €500m and, at the very upper end, has shown that it can provide financing as large as any term loan (up to €4.5bn to date).

That is not to say that the European private credit market doesn't have substantial room to grow further still. As with the earlier evolution of its liquid institutional credit market, the US also boasts a more mature and long-established private debt market. The transition to alternative financing sources in the US commenced in the late 1990s and was accelerated by the GFC. By contrast, it was only after 2008 that non-bank lenders first made meaningful in-roads into banks' market share in Europe. European private credit being a decade-plus behind the US in its growth trajectory is reflected by fewer private credit funds seeking to seize market share from banks in Europe compared to the US (250-300 funds in Europe vs. over 500 in the US).

Within that smaller cohort of European private credit providers, the competitive dynamics are tilted in favour of the most scaled players. The European private debt market is supplied by a smaller number of large funds than the US. The five largest managers headquartered in Europe account for 37% of all private debt capital raised since 2007 (vs. 23% in the US); the next 20 managers account for approximately that much again. That means the top 25 funds have effectively raised approximately 75% of all capital allocated to European private credit since the asset class's inception, compared to approximately 50% in the US. By contrast, the US market has a long tail of smaller funds. There are 400-500 managers outside the top 100 (10x the number outside the top 100 in Europe) who account for 20% of total capital raised (compared to 1% in Europe), i.e. $230bn (16x the total raised by their European equivalents, which stands at $14bn).

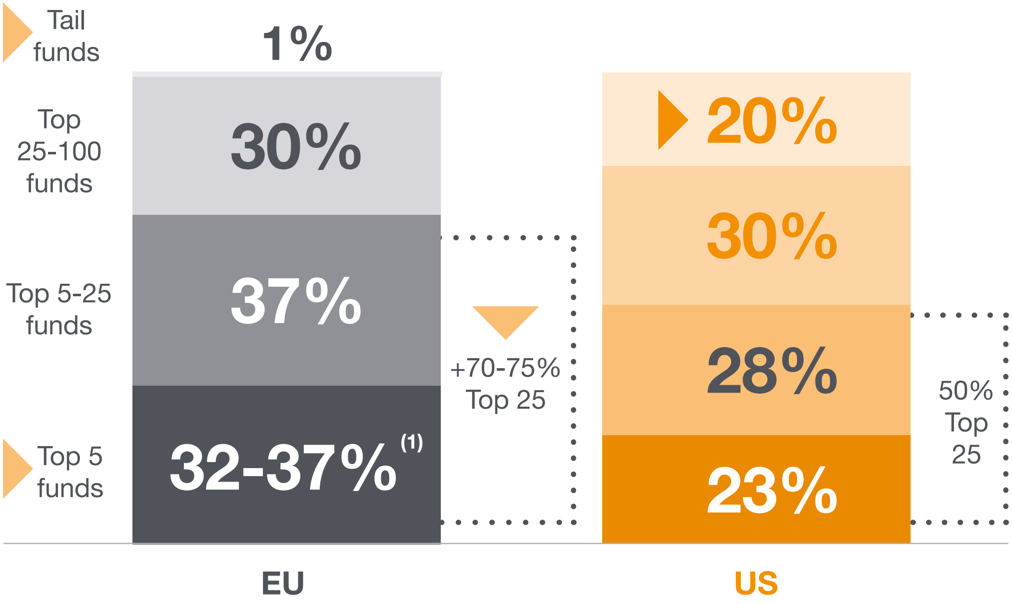
The European market therefore has fewer private credit funds with the scale to underwrite the large loans that account for an increasing share of total lending volumes. This is particularly true in the upper-mid-market range, where only a handful of large fund managers are capable of underwriting loans of €500m or more to businesses with EBITDA of €100m or more, which translates into better pricing and structuring dynamics.

Together, this means that there remains significantly more scope for European private credit funds to further disintermediate banks. This combination of a bigger supply of traditionally bank-led lending to poach from, a bigger pool of smaller, less robust institutions; a less deep and more volatile institutional credit market; and less competition from other private credit funds, particularly at the top end of the market; should, theoretically, result in better terms with lower leverage and more attractive risk-adjusted returns for private credit funds in Europe than in the US.

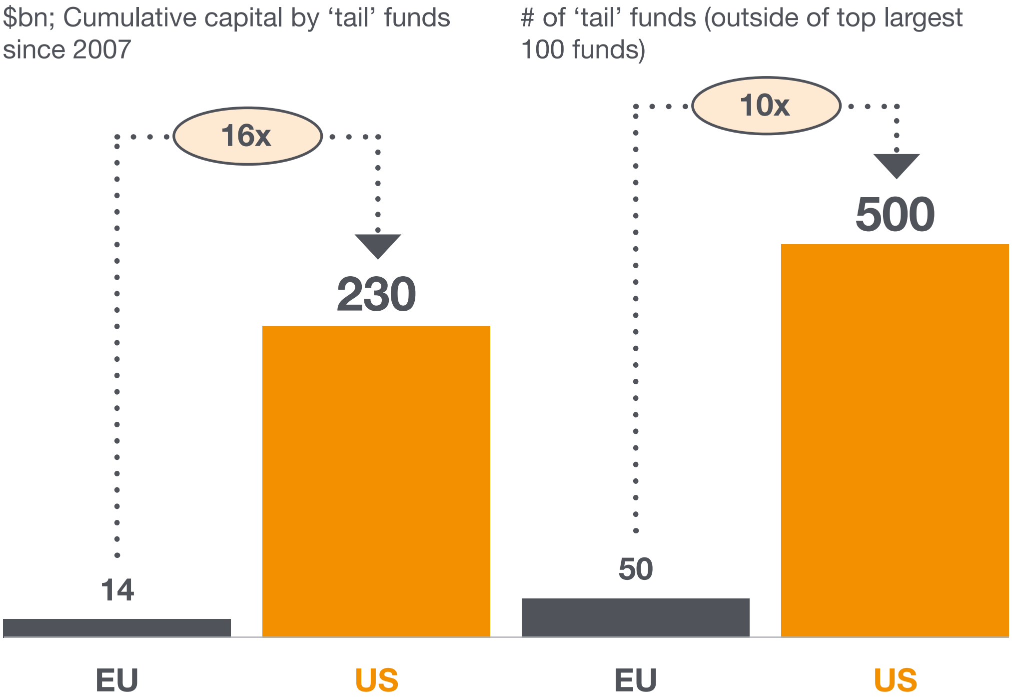
European market is dominated by a smaller number of players: Hayfin is one of the two largest European private debt managers

% share of cumulative fundraise capital since 2007

Source: Preqin



US Market with a long-tail of small funds holding a large pool of capital generating more competition on opportunities and pricing



Source: LCD as of August 23

Notes:
(1) Top end of the range excluding the only non-European fund of the Top 5, to show the metrics if we only analyse European headquartered managers

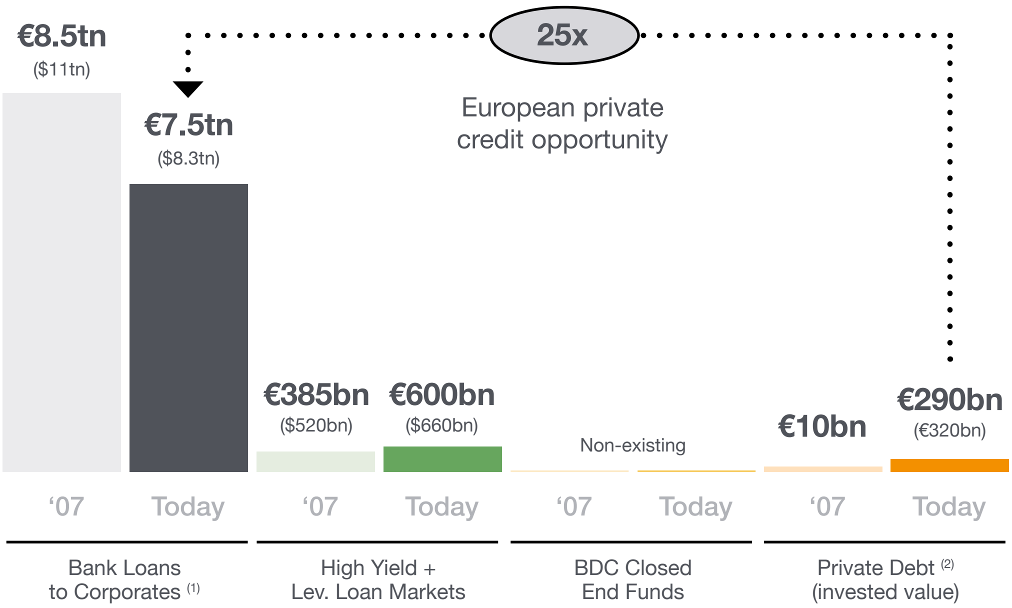
Our local offices in all the major Western European countries are staffed with investment professionals who have extensive relationships with key participants in those countries.

Why Europe?

Corporate lending at EU banks has declined by 15-20% vs. 2007 – 85% of Corporate Debt financing in Europe is provided by banks

$; Size of main debt financing sources in Europe

Sources:
LCD, EBA, FDIC, FRED St. Louis, EBF, BIS, Hayfin internal analysis

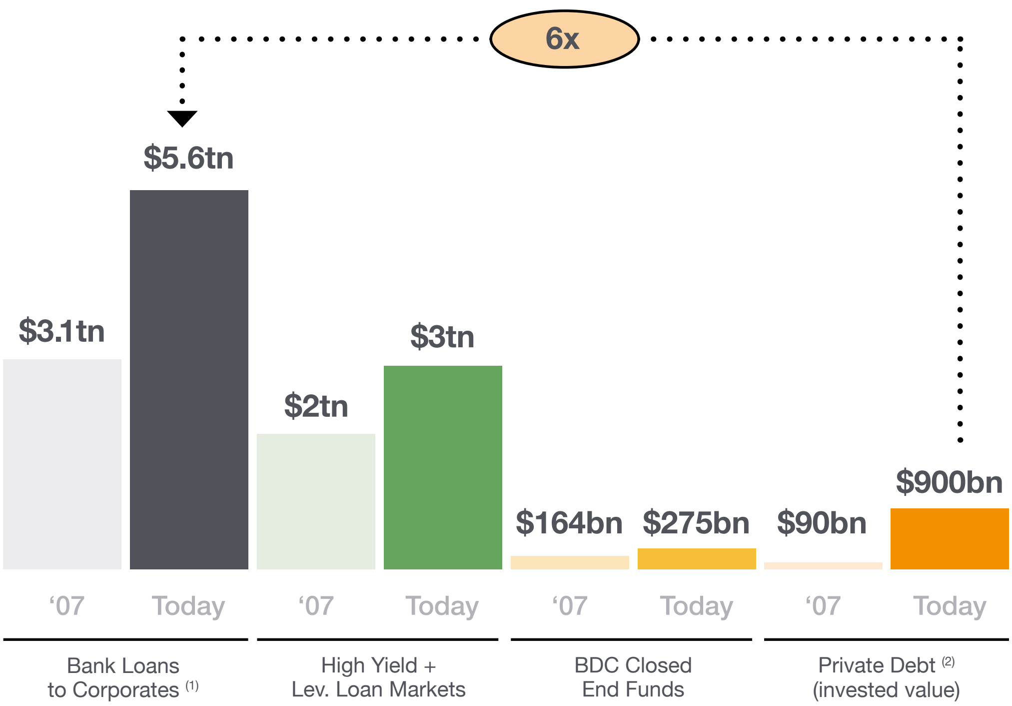


US banks have increased corporate lending by 1.8x vs. 2007, but bank financing represents only 50-55% of total debt financing sources

$; Size of main debt financing sources in the US

Sources:
LCD, EBA, FDIC, FRED, St. Louis, EBF, BIS

Notes:
(1) Non-financial corporate debt (ie excluding financing between banks) and including CRE loans; European banks loans only (excluding the UK banks);
(2) Including the UK markets



Regulatory and fiscal tailwinds in Europe

The latest wave of regulatory tightening, through the implementation of the Basel IV global banking supervisory standards, presents the next opportunity for private credit funds to further expand their market share. Historically, tighter regulation and supervision from the ECB and the Bank for International Settlements (BIS) has contributed to a reduction in bank lending to non-financial corporates. The reduction in bank lending in the period of the GFC to 2018 is estimated to be approximately €1tn in absolute terms and a 20% decline on a like-for-like basis.

This lighter treatment has allowed European banks to retain a greater share of corporate lending – but may now result in increased pressure to achieve a catch-up in supervisory standards.

SMEs have been particularly impacted by regulation causing banks to focus their lending on large corporates, where credit exposure is less capital-intensive. Each asset on a bank's balance sheet receives a risk-weight (calculated in line with guidance provided by the regulators set out in Basel directives) based on their risk profile. The higher the risk-weight, the more capital the bank has to hold against the asset. For example, for every €100 that a European bank lends to a "high-quality SME" (75% risk-weight), the bank must hold €75 in capital while for a large triple-A rated corporate debt the maximum amount is €20.

“A bigger supply of traditionally bank-led lending to poach from; a bigger pool of smaller, less robust institutions; a shallower and more volatile institutional credit market; and less competition from other funds should all result in better terms for European private credit funds.”

Mark Bickerstaffe

SME risk-weighting has been applied more punitively for US banks due to the Federal Reserve’s stricter approach. For the last 15 years, US banks have shown >2x higher aggregated Risk-Weighted Assets ratios (60-75% of total assets) than Europe (30-35% of total assets). The implementation of Basel IV will reduce banks’ flexibility to use internal-based risk models that these discrepancies between markets. Should European regulation trend towards aligning with the US, European banks will be required to record a higher percentage of risk-weighted assets, hold more capital against these, reduce their lending and therefore dilute the returns on bank capital. This will drive further bank retrenchment.

European governments’ fiscal policies have also paved the way for private credit funds to further supplant banks in the coming years. Government-backed support schemes set up during COVID-19 to ensure continued capital support for SME and large corporates saw loans channelled through banks, with 70-90% guaranteed by the state (depending on the country). By contrast, the US provided debt support via the SBA, an independent state agency of the US, with greater focus on tax breaks and other incentives. As a result, during COVID-19, Europe issued state-backed bank loans in excess of $2bn, more than 2.5x that issued in the US ($800m through public entities).

We would expect this to provide a positive backdrop for European private credit, as European banks are likely to need to clean up larger amounts of COVID-19 debt. This would suggest an opportunity for private lenders to either step in, as banks retrench from lending and refinance those loans, or to acquire a portion of those loans at a significant discount (with non-performing loans tending to peak 2-3 years following a downturn).

In Europe, both the long-term secular drivers and recent or upcoming market developments point to a greater opportunity for private credit funds to benefit from the disintermediation of banks than in a US market that is less bank-reliant, more intensively serviced by private credit and more stable.

Why Europe?

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2.

Europe: local market advantage

From a private credit investment perspective, Europe differs dramatically from the US in ways which extend far beyond the different structures and competitive dynamics of its respective banking, liquid credit and private credit markets. The differences also extend beyond questions of regulation and government policy. Many of the differences fundamentally stem from Europe's patchwork, heterogeneous nature which stands in stark contrast to the US. Europe comprises multiple individual national 'sub-markets' each operating under a separate legal jurisdiction with their own cultural, political and economic framework. This has major implications for how investors cover what we think of as the "market".

The benefits of boots on the ground

Firstly, in order to fully access European deal flow, you need longstanding relationships with the local sponsors, management teams, advisors and banks.

Certain continental European jurisdictions see a higher proportion of 'off-track' processes, i.e. those led by management and/or locally based sponsors, rather than intermediated by an advisor running a competitive auction among prospective debt providers. In that scenario, where a process has not been widely publicised, lenders need discretion, agility and knowledge of the local laws.

CEOs and local deal partners, who are already key in choosing a company's lenders, exert greater influence still in these management/local sponsor-led processes. They will typically favour one counterparty with local presence who is conversant in the local language, with whom they can deal bilaterally from inception to exit with confidence and trust in their reliability.

The lenders with longstanding local presence do not just benefit once from these tendencies. Incumbency provides privileged access to future deal flow, from a combination of add-ons and secondary LBOs, where lenders can position staple financings and bypass lender education processes. An established track record of running a portfolio through a credit cycle appeals to borrowers (both companies and sponsors), who can observe lenders' previous behaviour in a downturn and are generally more inclined to favour credit providers with proof of delivering reliably and acting collaboratively.

By contrast, funds without a local presence in France, Germany, Spain or Italy, for example, face the threat of adverse selection. They risk only getting access to deals from those markets which their competitors who are active on the ground have already seen and declined.

"The key prerequisite for investing successfully in Europe is to build a team that covers the entire breadth of the highly diverse and differentiated European market."

Tim Flynn

Exploiting inefficiencies in the European market

Secondly, because Europe is a less efficient and liquid market, credit cycles progress less uniformly than in a market like the US.

Typically, the early stages of a credit cycle are characterised by higher demand for credit and lower supply. This allows lenders to be highly selective in which companies they lend to and to agree more favourable financing terms.

As confidence builds and capital flows into the market, the supply of credit begins to outstrip demand for financing and terms tilt towards borrowers. Greater competition between lenders to finance a finite pool of deals erodes terms and investor protections in the borrowers' favour.

In the US, where it's typically easier to serve other regional markets from elsewhere in the country, the direct lending market 'heats up' at a relatively consistent pace across the country. By contrast, in Europe, this shift from a lender's market to a borrower's market happens more unevenly, because there are greater obstacles to capital flows. Different regions, sub-markets and niches remain underserved by capital, even as competition between lenders intensifies in other parts of the European market.

In order to be able to responsively dial down activity in an 'overheating' part of market and deploy capital where there is unaddressed borrower demand, managers need to have an established, developed and of scale sustainable, broad-based deal origination infrastructure.

The challenges facing managers arriving late to Europe

The key prerequisite for investing successfully in Europe, therefore, is to build a team that covers the entire breadth of the highly diverse and differentiated European market. This allows managers to be more selective, investing in markets where the lending dynamics are favourable and reducing activity where competition is at its most intense.

This regional presence requires a certain scale and takes many years to establish. Europe's leading private credit managers have spent over a decade developing their local networks. Presence and incumbency of this nature, together with a longstanding track record, provides a major advantage over new private credit funds, or US managers seeking to expand aggressively their operations, who might otherwise want to replicate this approach and access the same deal flow.

This contrasts sharply with the US, a more homogenous and efficient market which can mostly be covered from a number of coastal cities. The US direct lending market is more transactional and commoditisied. The capital of one lender is more fungible and easily interchangeable with that of the next.

This is convenient for borrowers – but also for new entrants on the lending side. As long as they have access to capital, they can undercut incumbent lenders on terms or pricing in order to access deal flow. Whilst the market behaves in an economically rational manner, European borrowers also value track record in investing consistently in the region and behaving reliably through the lifecycle of an investment.

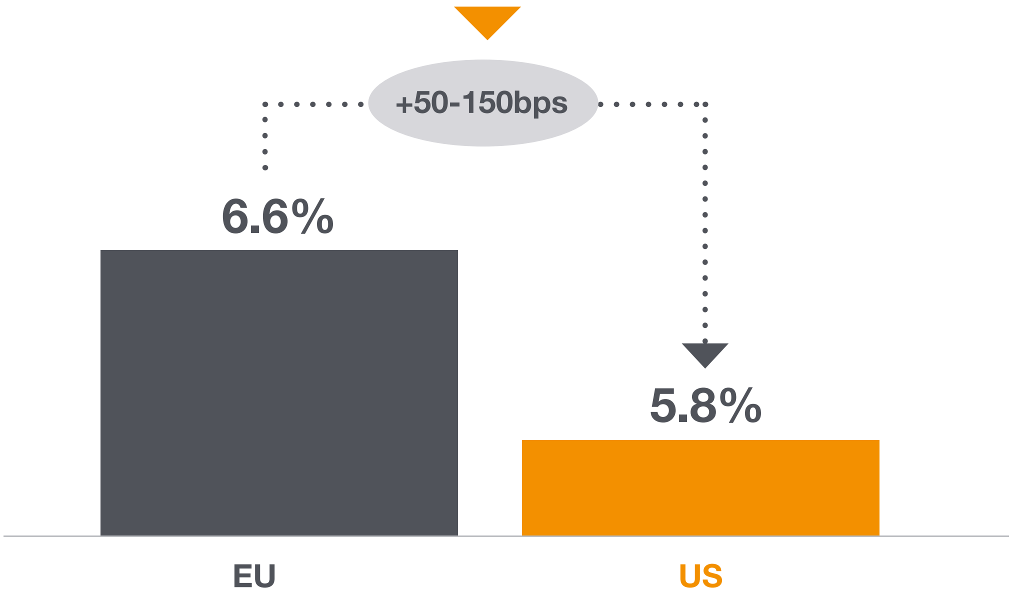
“We consider ourselves value investors, generating differentiated return through hard work, insightful analysis and disciplined investing.”

Stephen Badia

Why Europe?

European Private Debt market with higher absolute margins and lower leverage per transaction…

Average margin for Private Debt transactions
(Preqin 2022 Private Debt Report)



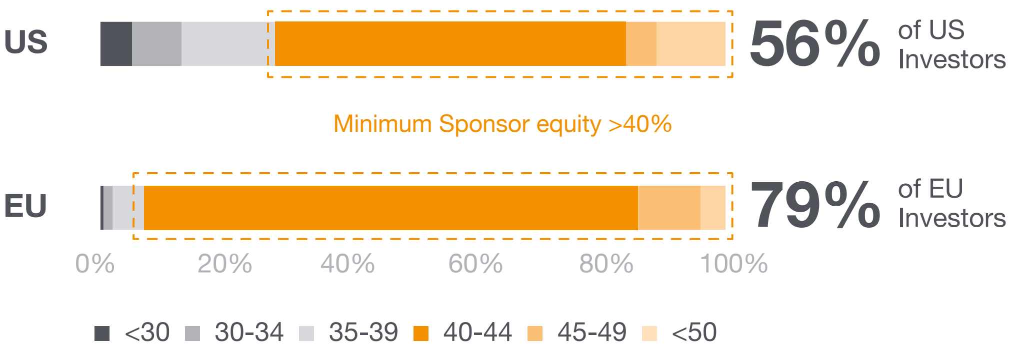
4.2x Average Senior Secured Leverage 4.8x

…and tighter documentation and higher equity cushion vs. more agressive US dynamics as the market is more fragmented there

Sources:
Preqin 2022 Private Debt Report, Proskauer Private Debt Survey 2022, JPM Research

Respondents requiring at least one covenant on a deal

Respondents to “How much equity does your organization typically require in your deal?”



Why Europe?

This slight distinction in borrower preference manifests itself in superior pricing for European lenders. Historically, there has been a 50-150bps return premium in Europe for private credit managers for lower levels of leverage (4.2x Europe vs. 4.8x in the US). This is because the national and geographic differences across Europe create a less homogeneous, less efficient market than the US, enabling private credit managers to arbitrage these differences and inefficiencies to optimise pricing and structure.

National champions can make for attractive mid-market lending prospects

The same market-structure dynamics mean that the middle and upper-middle-market companies which constitute the core borrower audience for direct lenders are often better insulated from competitive pressures in Europe than in the US.

In the US, a typical mid-market company, generating between $30m and $100m in annual earnings, will have many direct competitors. While different companies may have a greater foothold in different states or regions, any of these rivals poses a direct threat to their market share, abetted by greater inter-state legal and regulatory alignment.

Taken individually, the EU's largest member state economies account for 5%-15% of US GDP. An equivalent European mid-market company will as a consequence often be a national champion or have a more limited peer set than its US equivalent, which derisks these companies as credits.

Based on this combination of market factors, we believe that partnering with the right private credit managers in Europe allows clients to access differentiated deal flow offering superior risk-adjusted returns to those on offer in the US.

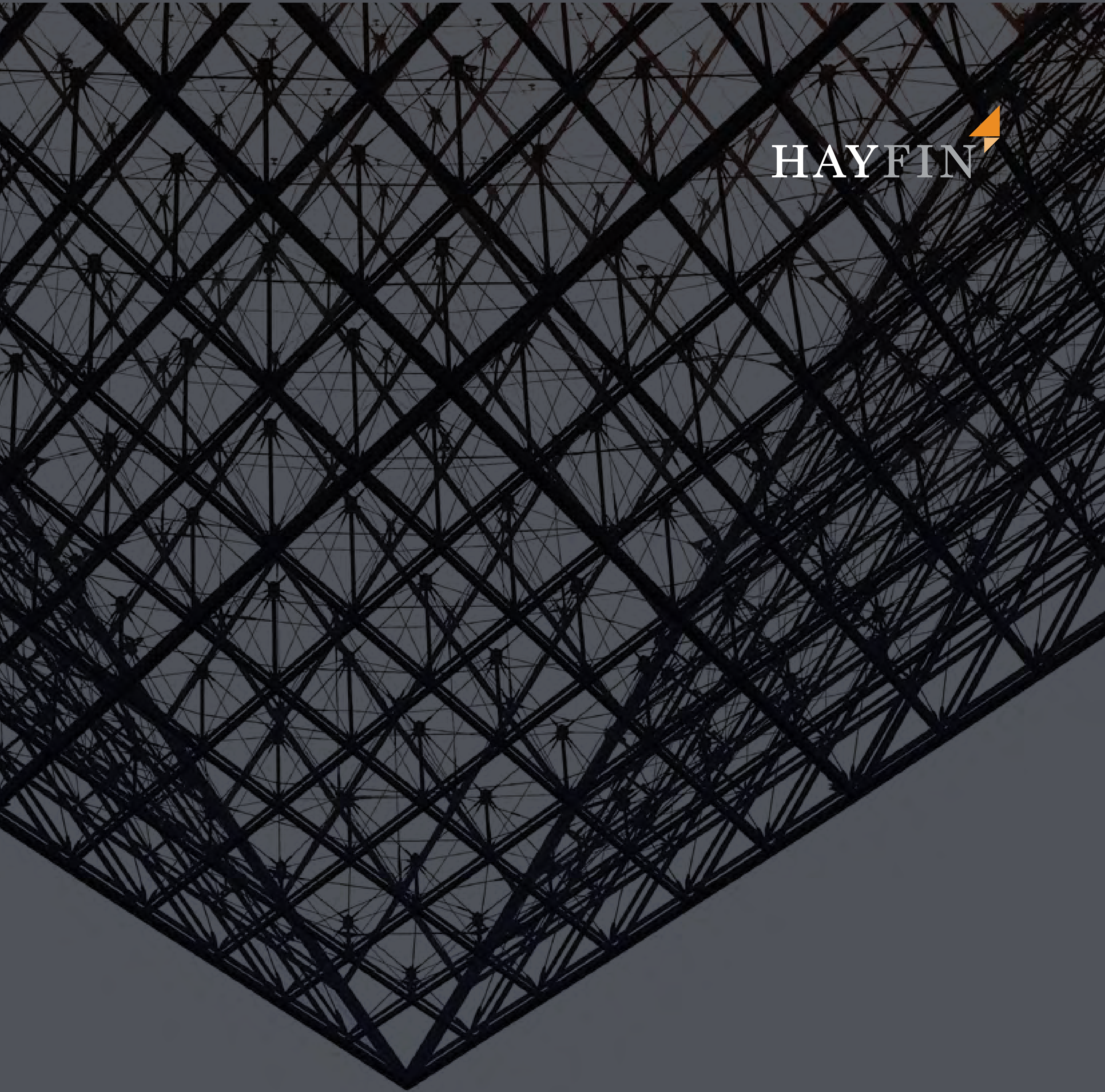
Why Europe?

A broad-based relationship approach to deal origination in Europe

Since Hayfin's inception in 2009, we have recognised the importance in private credit of originating investment opportunities from the widest possible pool. This allows a manager to select the best credit assets available offering the strongest risk-return proposition on behalf of its investors.

We also recognised that, in order to deliver on this approach and operate effectively as a private credit investor in Europe, you need a relationship-based approach with a deep local presence in each major market.

To provide ourselves with that flexibility, we drew on our institutional backing to scale the platform quickly following our establishment in 2009. Today, we have established local investment teams in all major European financial centres including London, Paris, Frankfurt, Madrid and Milan, comprising over 60 private credit professionals in total.



3.

Creditor rights: Western Europe vs. US

The challenges and opportunities of restructurings in Western Europe

It is not only in terms of deal origination and credit selection (as covered in the previous chapter) that Europe can appear too hard to understand relative to the United States, causing managers and investors to turn away from the market.

From the perspective of preserving capital in workout situations, Western Europe can, from the outside, look like a complex array of disparate restructuring and enforcement regimes, many of which seem to be weighted in the borrowers' favour.

"More than 85% of total European private credit issuance comprises first-lien secured lending with protections that are significantly better than the US."

Stephen Bourne

However, this is another disincentive to new entrants into European private credit, giving rise to a less competitive landscape for the incumbents. Moreover, we believe that the perception of the market as inherently challenging for creditors is based on an incomplete understanding of how these various regimes work.

In short, it is possible to invest in private credit in Western Europe in a creditor-friendly manner. Managers can benefit from reduced competition without necessarily compromising on creditor protections – as long as they have appropriately staffed teams, an established local presence, experience navigating each country's distinct restructuring and enforcement regimes and relationships with the pre-eminent legal and restructuring advisors and (where required) court-appointed restructuring officials.

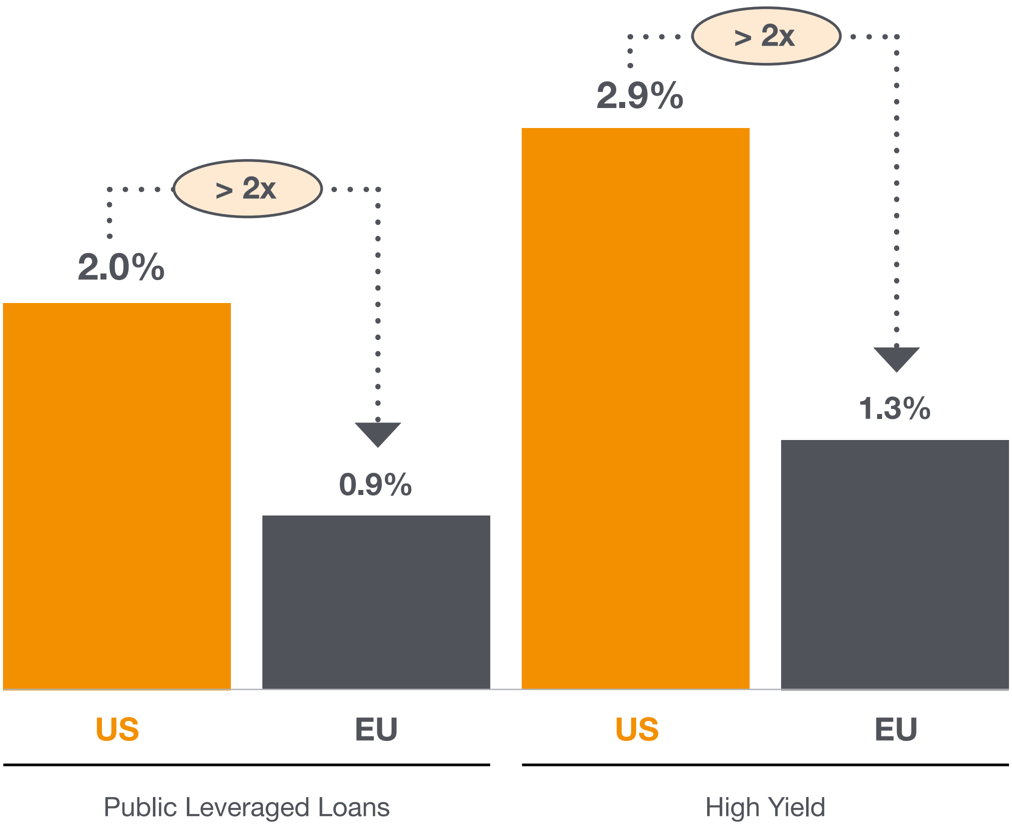
Indeed, >85% of total European private credit issuance comprises first-lien secured lending with protections that are significantly better than the US, particularly at the larger end of the market, where cov-lite loans in the US have long been the norm. Recovery rates for European leveraged loans were also higher than the US (65% vs. 59% respectively), driven not only by the higher equity cushions and more stringent underwriting standards that arise from the more lender-friendly market structure outlined in the previous chapter, but also by tighter documentation.

5-year average defaults in the US for leveraged loans and high-yield bonds nearly double those observed in Europe

% defaults

Source:

Credit Suisse Default Index.
Data as of December 31, 2021.

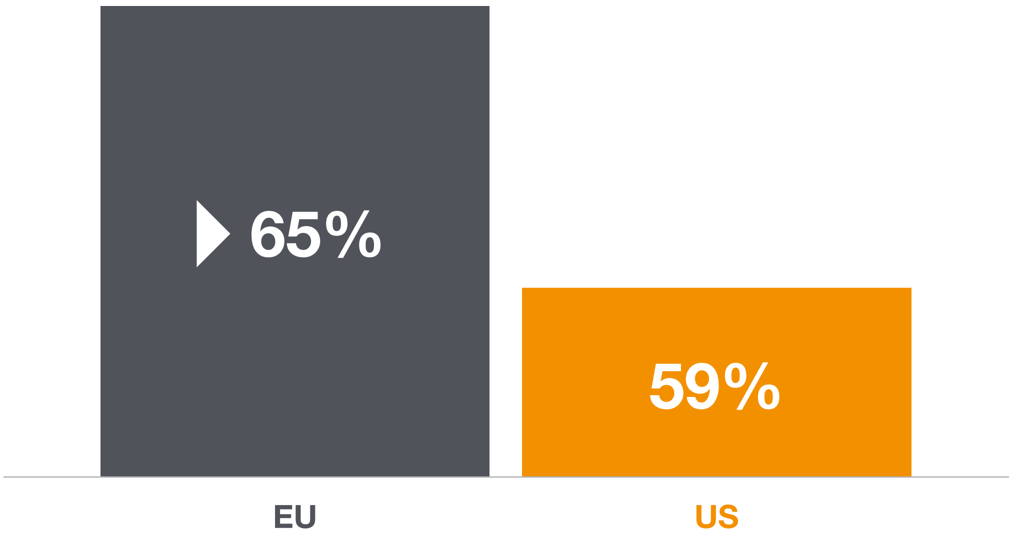


Recovery rates for EU leveraged loans are also higher than the US, driven partly by more stringent underwriting standards

% recovery rates
on leveraged loans

Source:

Credit Suisse.
Data as of December 31, 2021



Obtaining US-style creditor protections in Europe

There are steps that managers can take to minimise downside risk and better preserve investor capital in a restructuring scenario. However, the commonplace argument that this is necessary because Europe has significantly less creditor-friendly restructuring and enforcement regimes than the United States is a gross generalisation.

In fact, some European jurisdictions arguably afford creditors the same rights – or even, in some instances, better protections – which can be considerably more cost-effective and efficient than those in the United States.

“It is possible to invest in private credit in Western Europe in a creditor-friendly manner. Managers can benefit from reduced competition without necessarily compromising on creditor protections.”

Stephen Bourne

Dispute resolution in Western European jurisdictions

For instance, in terms of governing law and dispute resolution, English law is highly regarded around the world for its sophistication and predictability. The English courts are world-leading commercial courts and renowned for their specialist expertise and efficiency.

Regardless of the jurisdiction of the borrower or issuer, credit agreements for private credit transactions throughout Europe regularly specify that they are governed by English law, and that the English courts have exclusive jurisdiction to settle any disputes in connection with such agreements.

Similarly, New York law and the New York courts also tend to be used for high-yield bond indentures throughout Europe, regardless of the jurisdiction of the issuer.

The election of English or New York laws and courts for transactions outside such jurisdictions in Western Europe can give creditors greater comfort and certainty around how their credit agreements will be interpreted and how disputes in relation to such agreements will be resolved. In certain circumstances, it also allows debtors to avail themselves of the UK and US restructuring regimes.

Even if English or New York laws and courts are not selected for the credit agreements of Western European transactions, the legal systems in Western European jurisdictions are well-established, heavily grounded in the rule of law and moving in a more creditor-friendly direction.

Enforcement and restructuring tools in Western European jurisdictions

When looking at restructuring or enforcement in Western European jurisdictions, the UK, in particular, has a number of well-established tools including self-help enforcement remedies for creditors which do not require court oversight (e.g. pre-pack administrations and share pledge enforcements or appropriations) and restructuring processes including schemes of arrangement, restructuring plans and company voluntary arrangements. These remedies and restructuring processes are flexible, cost-effective and predictable, with a well-established track record for not being value-destructive. By contrast, Chapter 11 in the US is often a very expensive and long process that places significant control in the hands of the debtor vs. creditors.

Other jurisdictions, such as Luxembourg, also have creditor-friendly enforcement processes which do not require court involvement and are predictable, cost-effective and extremely efficient. In the event that creditors are concerned about a jurisdiction's potential unpredictability, the inefficiency of its local courts or any other factors, they can often structure the transaction to avoid being embroiled in a restructuring there and instead make use of these more creditor-friendly jurisdictions. One way this can happen is by overlaying a Luxembourg holding company structure on top of the debtor incorporated in another Western European jurisdiction, where such holding companies provide security over the shares in one of the Luxembourg holding companies.

In addition a European Union restructuring directive has resulted in all major Western European jurisdictions (including the UK, in spite of its departure from the EU) either adopting or beginning the process to adopt more sophisticated and creditor-friendly restructuring regimes. The directive, inspired by leading restructuring jurisdictions including Chapter 11 processes in the United States and schemes of arrangement in the United Kingdom, sought to introduce a more unified and effective preventative restructuring framework, which was not value-destructive and should enhance the rights of creditors.

Key features of many of these new restructuring regimes include:

- **Procedures strengthening the speed and effectiveness of amicable settlement procedures between debtors and creditors.**
- **The creation of classes of active parties based on commonality of interests of creditors (including based on ranking under contractual subordination arrangements) and, in many instances, the adoption of a concept akin to the "absolute priority rule" found in Chapter 11 processes in the United States.**
- **Processes to enhance the involvement of "in-the-money" creditors and reduce the ability of equity holders or "out-of-the-money" creditors to thwart restructuring plans which affect their interests.**
- **Both in-class and cross-class cram-down mechanisms.**

This has led to better risk-adjusted returns and lower volatility in Europe vs. the US. US credit markets have historically seen higher default rates than those in Europe, with 5-year average defaults in the US for leveraged loans and high-yield bonds more than 2x those observed in Europe. This pattern is also seen in private credit, with the European private credit default rate at c. 2% vs. more than 4% in the US.

An investment team prepared for workouts

Hayfin has structured its investment team to meet the exact specification required to benefit from reduced competition in European private credit markets without compromising on creditor protections: appropriately staffed teams, an established local presence, experience navigating each country's distinct restructuring and enforcement regimes and relationships with the pre-eminent legal and restructuring advisors and (where required) court-appointed restructuring officials.

Our local offices in all the major Western European countries are staffed with investment professionals who have extensive relationships not only with local advisors, banks, sponsors and borrowers in order to aid deal origination, but also with key participants in those countries' restructuring and enforcement sectors.

We have also invested in a large in-house execution and workouts team, consisting of five full-time legal professionals. This team is solely dedicated to the structuring, execution and (if necessary) restructuring of Hayfin's investments. They have extensive legal knowledge and practical experience of the restructuring and enforcement regimes of all major Western European countries, having been involved in over 80 restructurings across Western Europe.

Through our network of local investment professionals and in-house execution and workouts team, we devote extensive time and attention to understanding creditor rights in the relevant jurisdictions before making any investment. Where necessary, we will devise structural enhancements to mitigate against any particular jurisdictional concerns associated with a particular investment.

Hayfin has the team with the necessary understanding and experience to navigate their way through these issues and structure transactions in Western Europe in a way that ensures that they provide creditors with sufficient protections in a downside scenario. Our European loan book for our private credit strategies comprises a significantly higher percentage of first-lien secured lending with stronger protections than the industry-wide average of 85%.

HAYFIN

Conclusion

Why Europe for private credit?

We believe private credit has become a sufficiently well-established asset class to command a sizeable, multi-trillion-dollar share of institutional allocators' holdings for the foreseeable future.

The primary question facing investors is no longer 'Why private credit?' The biggest drivers for allocators are now widely understood, including a growing addressable market, low-volatility risk-adjusted returns comprising a substantial regular cash yield component and predictable return on capital

Instead, investors are asking, in an increasingly competitive global landscape, 'which strategy?', 'which market?' and 'which manager?'.

As laid out in this paper, we believe that those investing in European private credit can convincingly answer the question of 'Why Europe?', with reference to three key arguments:

1. **The opportunity set for private credit is defined, in part, in opposition to the lending appetite of the banking sector. Given Europe is still a more bank-centric market with less developed, liquid and resilient capital markets than the US, there is greater scope for private credit to seize more market share in Europe in the near to medium term, accessing a larger supply of new deal flow on more attractive terms than in markets where the industry is more mature.**
2. **Europe's heterogeneous nature, as a patchwork of multiple different national 'sub-markets' operating under distinct cultures, languages and legal jurisdictions, allows a small subset of sophisticated, locally based lenders to access and capitalise on investment opportunities on more lender-friendly terms than is available in more liquid, efficient and homogenous markets, where credit cycles progress more uniformly.**
3. **Contrary to the widespread perception of the US being a more creditor-friendly jurisdiction than Western European markets, it is possible to invest in private credit in Western Europe in a creditor-friendly manner (with recovery rates in Europe having historically been higher than in the US), while the perception of restructuring regimes weighted in borrowers' favour deters new capital from flowing into the market, to the advantage of the incumbent and locally based lenders.**

Not all European private credit managers are created equally. Moreover, not all European private credit managers are equally well-placed to benefit from these structural factors. In fact, the opportunity for certain lenders to access and capitalise on this deal flow results in adverse selection for other managers.

In order to capture the potential upside of the European private credit market, managers need:

1. **The firepower to capitalise on further retrenchment from leveraged lending by European banks – restricted in large part to the 25 biggest European managers who have accounted for 70%+ of all private debt fundraising since 2007.**
2. **The local presence across all major European financial centres to originate investment opportunities from the widest possible pool, allowing them to select the best available credit assets offering the strongest risk-return proposition on behalf of their investors.**
3. **An investment team with the requisite experience and expertise to navigate each country's distinct restructuring and enforcement regimes, relationships with the preeminent legal and restructuring advisors and (where required) court-appointed restructuring officials, and a dedicated in-house resource for execution and workouts.**

We believe investors who partner with managers with these important differentiating characteristics will gain the highest-quality exposure to the European private credit market, and thereby benefit from some of the strongest risk-adjusted returns on offer from the asset class globally.

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