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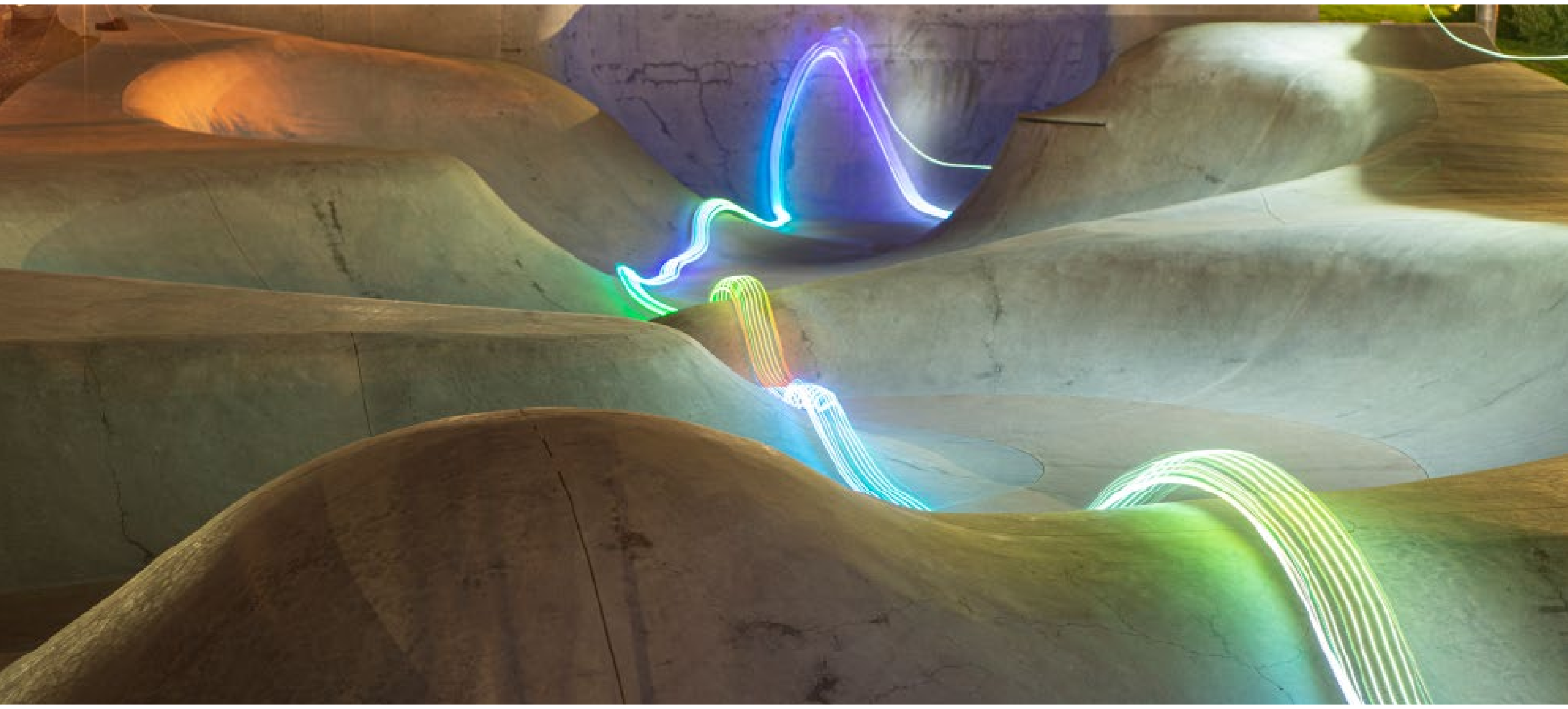
European leveraged loans outlook 2025: The recovery continues



As we enter 2025, optimism surrounding the European leveraged loans market builds despite the geopolitical backdrop remaining unpredictable. This outlook reviews the factors that defined the European loans market in 2024 and discusses the key drivers likely to impact it over the next 12 months.

Following relatively subdued issuance in 2023, the European broadly syndicated loans (BSL) market experienced steady growth in 2024. A modest rise in M&A partly explains this expansion, but more significantly, it was attributable to refinancing, recapitalising and the raising of add-on tranches for the existing stock.

Given the bumper buyouts of 2021 – and the tricky conditions thereafter that have extended holding time-to-realisation for sponsors beyond their original expectations – a large number of mature capital structures needed to be extended in 2024, with conditions still not ideal for general partners (GPs) to exit.

That said, refinancing extended beyond the existing community at times, with brand new entrants being seen in the BSL market, as companies left the private credit arena for the larger, liquid, alternative private market. Improved credit conditions in 2024, driven by modestly falling interest rates, helped deal-making to improve on the previous year, while yields still remained sufficiently high to keep loans and collateralised loan obligation (CLO) tranches competitive versus other investments, securing solid investor demand.

The European Central Bank is in rate-cutting mode, confident in its ability to bring inflation into line with its 2% target and suggesting more scope for deal flow and easier conditions for borrowers. Improving valuations that may result could therefore lead to a growing number of exits by sponsors, the pre-requisite for meaningful pick-up in new buyouts, making for rejuvenation of the market and a more significantly expansionary year ahead. Against that remains the unknowable impact on global trade and other foreign policies to be pursued by the new US administration, to say nothing of the tense situation in the Middle East and its potential to spill over.

2024 European loans review

Resilient performance and fundamentals

Despite a subdued macroeconomic backdrop, lower base-rates and tighter credit spreads, the European BSL market delivered strong returns in 2024 of 8.53% in EUR terms (10% in GBP), matching high yield bonds and outperforming other fixed income market segments such as European investment grade bonds (4.66%) and European government bonds (1.76%). This was achieved with lower gyrations along the way.

> **"Despite falling base rates, the European leveraged loans market delivered strong returns, outperforming many fixed-rate market segments."**

Fundamentals held up remarkably well too, meaning that stress and default ratios were very low. Total leverage within the European loan market remained flat – at around 5x – and interest coverage ratios, though slightly reduced, remained above 2.5[1]. Sponsor alignment with lenders continued too, with the equity quotient in sponsor-led deals persisting at c.48% of total company value.

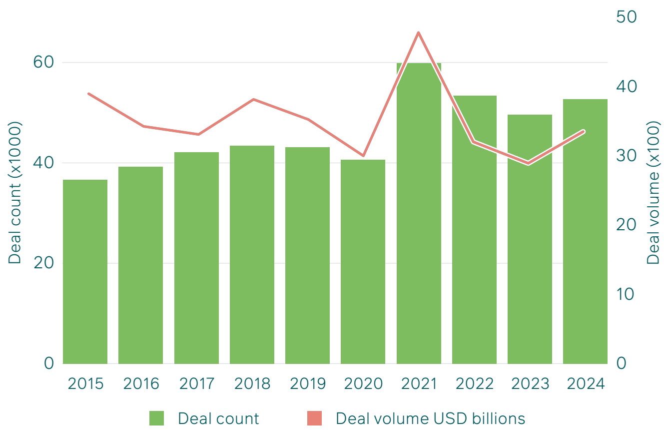
EUR Hedged	European Loans	European Investment Grade	European Government
2024 Return	8.53%	4.66%	1.76%
2024 Volatility	1.27%	3.20%	4.66%

Source: European Loans: S&P UBS Western European Leveraged Loan Index, European Investment Grade: ICE BofA Euro Corporate Index, European Government: ICE BofA Euro Government Index. European Hedged as of 31 December 2024.

Acquisitions and IPOs subdued

Emerging from a slow M&A market in 2023 – that was itself 40% down on the stellar activity of 2021 – expectations were high for 2024 to mark a sustained recovery in exits and buyouts. Both sponsors and investors were keen to realise profits on seasoned deals and to recycle capital. However, global M&A volume – though higher than 2023 – was constrained for most of the year, as geopolitical pressures persisted and as the nature of the economic landing, hard or soft, proved elusive to discern for most of the year. Accordingly, private equity sponsors continued to shore up their capital for longer holding-times: continuation vehicles have risen sixfold since 2020, protecting value of $50-60 billion[2], while NAV financing has been another, sometimes controversial source of bolstering. Lenders have had a better chance than limited partners (LPs) to recycle their portfolios, being able to continue or quit at will as company debt extensions require their consent.

Global M&A activity



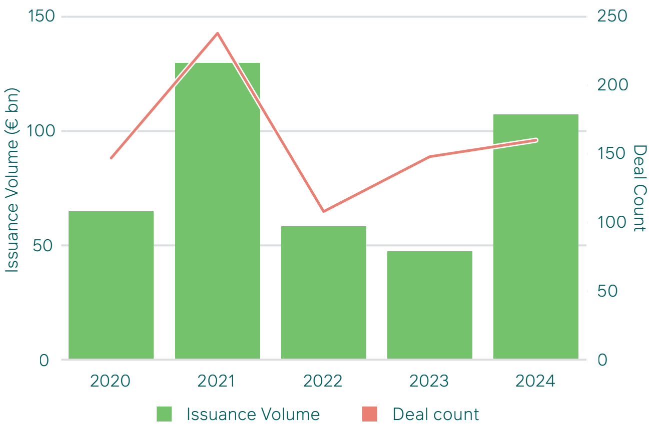
Source: Bloomberg as of 31 December 2024.

Issuance rebounded

Despite subdued M&A, loan supply in 2024 surprised to the upside, with total issuance of €107 billion being seen – more than double 2023's €47 billion. While refinancing accounted for half the volume – just as it did the year before. It included new entrants from the private credit arena, ensuring an expansion of the BSL market and its constituents. Furthermore, M&A-driven deal volume hit a three year high of almost €40 billion[3]. This rebound was particularly apparent in H2, when EUR base rates fell by almost a point. That said, the proportional share of M&A-related issuance of 40% was still only half its historic average (based on deal count).

[1] Pitchbook, 'European Credit Markets Quarterly Wrap', (pitchbook.com), Q3 2024.
[2] Pitchbook, 'GP Led Secondaries', (pitchbook.com), Q4 2024.
[3] Pitchbook, 'Leverage Loan Volume Report', (pitchbook.com), 31 December 2024.

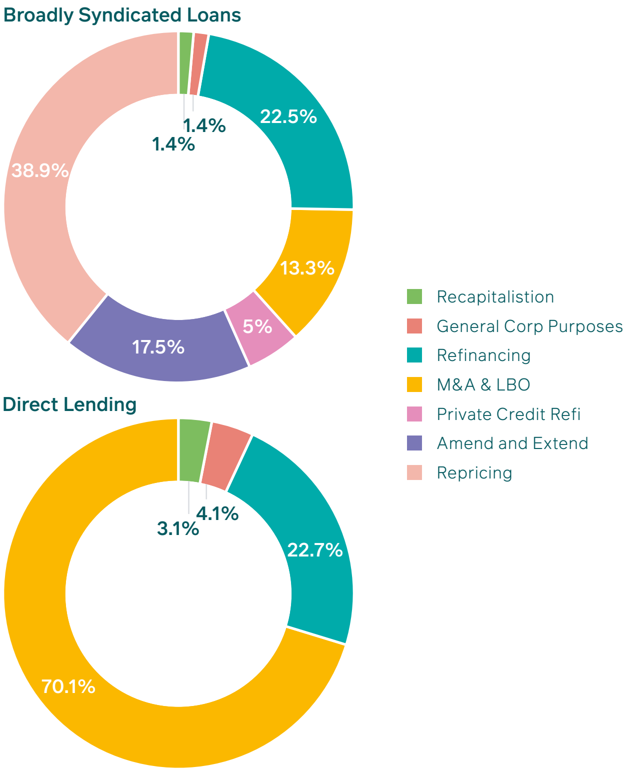
Broadly syndicated loans issuance bounces back



Source: Pitchbook European Credit Markets Quarterly Wrap and Leveraged Loan Volume Report.Count of deals as of 30 September 2024, BSL Issuance as of 31 December 2024.

Within the refinancings, came a surge of sizeable deals, such as Dechra, OCS and April, that moved companies away from unitranche financing to the better economics and terms of the BSL market. Direct lenders in the large-cap space experienced considerable competition for assets as a result, sometimes choosing to differentiate themselves with higher risk tolerance or solution provision such as the provision of PIK financing. Consequently, the BSL market became more confidently a 'single B' market in 2024, with weak B and CCC equivalent risk being more commonly tolerated by the private credit investor base.

European private credit issuance



Source: Pitchbook European Credit Markets Quarterly Q3 2024, and 9Fin European Leveraged Loans Outlook 2024.

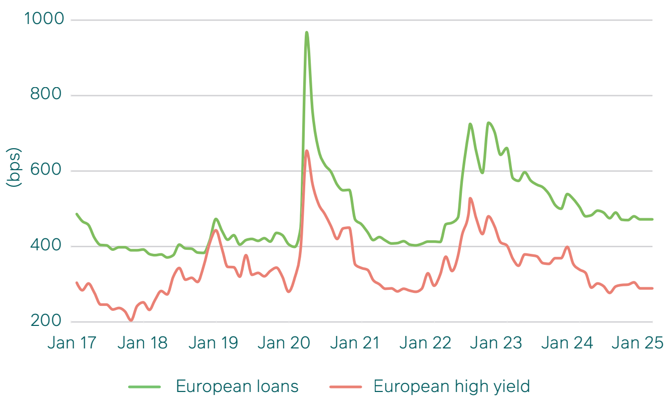
> **"The main driver for new issuance came from refinancings, not M&A activity."**

Higher demand leveraging larger market

Despite repricing activity and more measured new money issuance, the size of the European loan market grew by €12 billion to €420 billion[4], an extra €100 billion to pre-COVID levels and a near threefold increase in size over the last decade. In contrast, the high yield market shrank by about €10 billion to €366 billion over the past year[5].

This extra loan capacity was easily digested, with demand largely being driven by CLOs whose new issuance reached a record-breaking €48 billion, alongside €34 billion of refinancing and resets[6]. Away from CLOs – and in addition to steady institutional demand for loans – new sources of BSL demand, such as wholesale investors, via ELTIFs, and family offices were seen, meaning that the prospect of liquidity with high yield evidentially piqued interest. This all contributed to net undersupply – a driver of spread compression over the year of c.30bps. Loan spreads remain wider than their pre-COVID average, and significantly higher than European High Yield, hinting at remaining excess value ahead.

Spread premium 2017 to 2024 YTD



Source: European Loans: S&P UBS Western European Leveraged Loan Index 3-Year Discount Margin, European High Yield: ICE BofA European Currency Non-Financial High Yield 2% Constrained Index Asset Swapped Spread as of 31 December 2024.

[4] S&P Global, 'Face value S&P UBS Western European Leveraged Loan Index', (spglobal.com), 31 December 2024.
[5] ICE Indices, 'Face value ICE BofA European Currency Non-Financial High Yield 2% Constrained Index', (indices.ice.com), 31 December 2024.
[6] Pitchbook, 'CLO Volume Report', (pitchbook.com), 31 December 2024.

Defaults remained subdued

Despite lacklustre economic growth and high interest rates, speculative grade default rates remained low. Europe's soft-landing and numerous extensions contributed to this resilience. For European loans specifically, defaults were forecasted to peak at 3-4% in 2024 but fell every quarter, reaching just 0.4% by year end[7]. Nevertheless, lenders increasingly need to look beyond technical defaults which are only a part of the distressed picture. The rise of lender-on-lender violence via Liability Management Exercises (LMEs), such as up-tiering a new group of lender rights, or down-dropping via asset leakage to a non-restricted subsidiary, are potentially a cause for concern for European lenders from here even if this has been largely a US problem to date given weaker documentation, lower guarantees and lower personal liabilities for company directors.

> **"Despite lacklustre economic growth and higher interest rates, default rates remained low."**

The index comeback kid

The two largest index providers within the asset class have experienced significant turnover in the last 18 months. After selling the S&P Leveraged Loan Index franchise to Pitchbook Morningstar in H2 2022, S&P has returned to loan indices. UBS outsourced the former Credit Suisse leveraged loan indices calculations to S&P in late 2024. This could be a positive for data quality and attribution as we will likely see a narrowing of index differences, sector and rating-wise, allowing better comparability.

2025 European loans outlook

Reopening of acquisitions and IPOs?

Can the mild M&A recovery, observed since mid-2024, pick-up pace in 2025? There are grounds to expect the main factor that has limited activity thus far – the disconnect between business owners' valuation expectations and potential buyers' willingness to pay them – to loosen. Lower rates both reduce debt financing costs and boost corporate cashflows, supporting higher valuations, meaning further monetary easing should be an accelerant. Expectations are high for a pace-change in 2025, particularly for exits to begin in earnest, with Goldman Sachs predicting a doubling of tech IPOs in 2025. Furthermore, according to Pitchbook, PE-backed companies are expected to capture 40% of all IPO capital raised on US exchanges in 2025, up near 10% versus long-term averages. European bourses may not be able to compete and Q1 may prove unpredictable not least owing to a German election.

That said, with disinflation underway and given the anticipated rate cuts ahead, the backlog of seasoned buyouts looking to be realised by PE owners could underpin significant European equity capital markets activity in 2025, potentially doubling the $25 billion of gross proceeds raised from IPOs and sell-downs that was raised in 2024. Already lining up to repeat the multi-billion success of Galderma's listing by EQT in 2024, are German generic drugmaker, Stada; Spanish travel technology firm HBX; and Dutch telco, Odido.

Public equity markets resist high leverage so there may have to be some structural creativity to achieve a listing in some instances, whether via Holdco PIK (akin to a margin loan) or pre-IPO share placement. As far as new buyouts are concerned, the UK may be expected to be active. Its persistently 'cheap' listed companies are tempting takeover attempts, including Apollo-owned ABC Technologies' £1 billion move on TI Fluid Systems and Fortress's £340 million takeover of restaurant group, Loungers plc. This should have knock on deal-making effects, arising from sponsor and investor confidence, with associated loan deal flow naturally following through.

[7] Pitchbook, 'European Leveraged Loan Index Rolling 12M Default Rate', (pitchbook.com), 31 December 2024.

Steady margins, strong returns

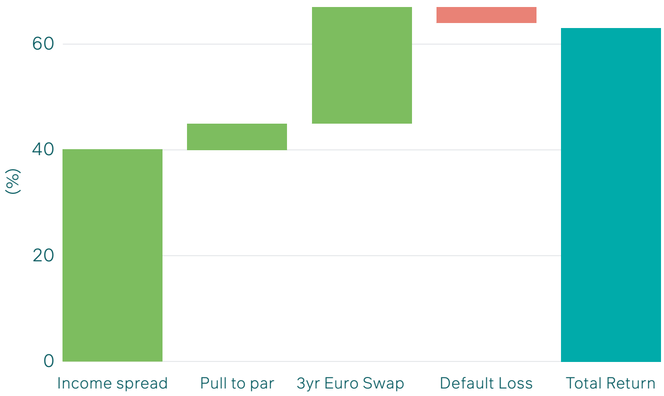
Notwithstanding 2024's strong outturn, we believe there remains significant potential for attractive returns from BSLs. Average secondary marks are still discounted around 98, and, although new-issue spreads have compressed, they begin the year at approximately 400 basis points above risk-free rates. This translates to a potential, all-in annual gross yield of 6.5% in EUR terms (9.2% in GBP) over the next three years, barring any unforeseen global macroeconomic shocks or shifts in the rates curve from current expectations. This is over 0.5% higher than high yield bond prospective yields, benefits from a rallying rate environment in 2025 for fixed-rate instruments notwithstanding. Indeed, ahead of any cuts, loans begin 2025 with current yields of near 7.5%. Pleasingly too, in a macro landscape that holds potential for surprises, nearly all of the anticipated loan returns ahead comes from carry.

The impact from default loss for BSL – that is largely senior secured – should remain low, with Moody's having restored all industry sectors (bar Autos) to a stable or positive outlook, at the same time as tempering its expectations for speculative grade defaults overall to just 2.7% in 2025, a 20% decline. S&P is more pessimistic about the outlook for sub-investment grade credit risk overall, predicting 4.25% next year, but with the same downward trajectory from its assessment of a year earlier (4.6%). For loans specifically, Barclays forecasts only a 1% default rate though notes that potential distressed exchanges are not included in that estimate.

To fail to achieve a real return, defaults would need to reach a cumulative level of over 30% over the next three years, with a recovery rate of only 50% versus historic averages of 75% – a scenario that has never occurred in any credit market, particularly in a defensive one like loans.

> "There remains significant potential for attractive returns in the leveraged loan asset class, with overall margins stable."

Prospective European loan returns



Source: M&G for illustrative purposes only. Bloomberg swap rate as of 31 December 2024. Default Loss assumes Barclays forecast of 1% default rate and long-term recovery of 70%.

Interplay between BSL and private credit

2025 may see more symbiosis between the liquid and illiquid loan markets as the risk differentiation becomes better understood. 'Story' credits, specialist sectors may attract long-term capital that will not seek standardisation nor ratings, while large issuers, many of which are on a trajectory to public listing, will commonly choose to issue in the BSL market.

Competitive forces will not be entirely absent. Just as portability crept into some loan deals in both markets in 2024 – to enhance the sale options for the incumbent owner – so this might remain a bargaining tool to preserve a lender's exposure to a company in 2025. The challenge for private credit is the inability to sell into a secondary market, were the new owner to disappoint, making this a riskier feature.

ESG Trends

The 'low hanging fruit' of ESG disclosure has now largely been picked (carbon emissions, D&I statistics), and, ten years on from Paris, 2025 will see yet more focus on companies' forward-looking transition plans – which are required by the Corporate Sustainability Reporting Directive (CSRD). It will be crucial to apply sufficient scrutiny to net-zero pledges, including assessing their ambition, coverage, and decarbonisation levers to make sure that the targets are realistic.

2025 will see the first set of companies report under the new CSRD regulation, under which most BSL companies will be captured. The enhanced sustainability disclosure and assurance requirements of CSRD will democratise ESG data availability and permit better-informed sustainable investment decisions. With the increasing polarisation between EU and US investor attitudes to sustainability, likely to be exacerbated by an inbound climate-sceptic US administration, the enhanced disclosure and discipline that the EU may provide, could see capital more easily attracted to European companies from sustainability-focused, EU regulated investors.

The loans landscape ahead

The European loan market has efficiently pushed out its maturities, repriced its debt, and thereby stabilised corporate capital structures, putting it in strong shape as the new year begins. Technical and structural supports for the market are in place, with encouraging signs of M&A and IPO activity. While absolute issuance in 2025 may prove lower than 2024, net new money is expected to be higher, relative to repricings/refinancing. With focus turning to primary deal flow, loan secondary marks will likely remain slightly discounted, offering investors a good opportunity to capture attractive, default-adjusted yields of over 6% in EUR terms. Defaults may be subdued, but distress will be present and volatility cannot be ruled out, such are the geopolitical conditions and unclear outlook for world trade. The fundamentals of credit investing, focusing on downside risk mitigation including ESG risks, remain as crucial as ever. Seniority, security, diversification and defensiveness are all natural features of conservative European loan investing.

Investors have seen strong returns from European leveraged loans over the past few years and this trend is expected to continue over the next 12 months.

> **“The enhanced sustainability disclosure and assurance requirements of CSRD will democratise ESG data availability and better inform sustainable investment decisions.”**

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