PERMIRA CREDIT MARKET UPDATE Q1 2024

In partnership with Capital Economics

Please note that the views described herein represent those of Permira Credit and Capital Economics as at Q1 2024.

- **Following a challenging year in 2023, the outlook for private credit in 2024 is brighter, as a relatively more stable economic environment brings renewed optimism for a pick-up in activity.**
- **While interest rate cuts are on the horizon, the pace of the economic recovery across Europe will be muted as some headwinds persist. In the medium-term, the AI revolution is likely to lift potential growth, which will contribute to nominal policy rates settling at higher levels than pre-pandemic.**
- **Against this macro backdrop, there is ample opportunity for private credit markets to thrive. With uncertainty diminishing, record levels of dry powder are ready to be deployed, and M&A activity is resuming, particularly in the mid-market.**

Economic outlook

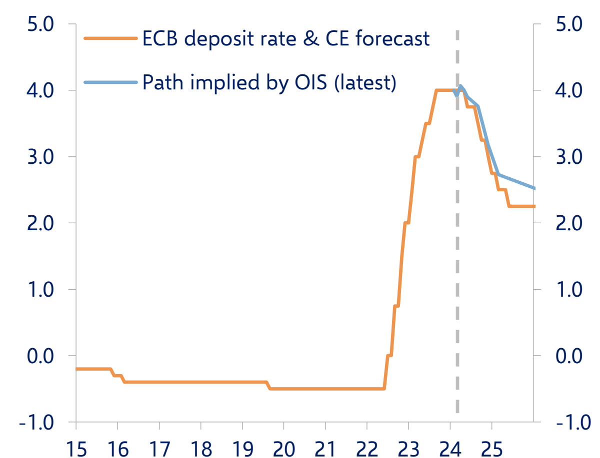
ECB rate cuts on the horizon as inflation falls

The European economy has been relatively resilient following the pandemic to what has been a significant energy-driven inflationary shock and an aggressive policy tightening cycle. Although euro-zone GDP growth has undoubtedly been weak since 2022, the impact on the economy has been far less severe than the significant recession many feared.

The energy price shock has now largely reversed, but headwinds remain. Tighter fiscal policy across the region will dampen economic growth, and stalling employment growth and slowing wage growth will limit consumption. All this means we expect the euro-zone economy to grow by only 0.2% year-on-year in 2024. Prospects should improve later this year and into 2025 as inflation continues to fall and interest rates are gradually cut.

Rate cuts could come as early as June, but when they do, we think the ECB will move cautiously. After all, the labour market remains relatively strong which could yet sustain upward pressure on wages. And while headline inflation could fall to 2% in the summer from its 2022 double-digit highs, we expect the core rate – inflation excluding volatile energy and food prices, which better reflects domestically-driven inflationary pressures – to stay slightly higher for longer. Given this, we expect the ECB deposit rate to fall from 4.00% currently to 3.00% by the end of 2024 and 2.25% by mid-2025. (See Chart 1.)

Chart 1: ECB Deposit Rate and Market Expectations (%)



Sources: Capital Economics and Refinitiv

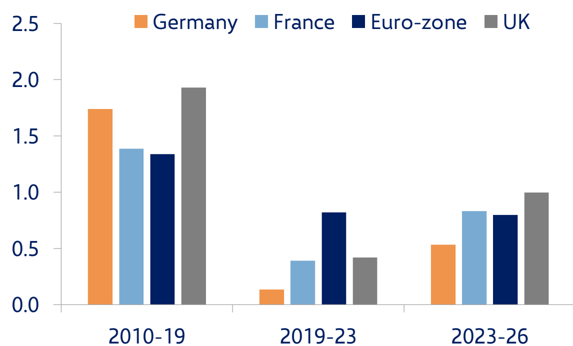
Economic recoveries to be gradual

Within the euro-zone, Germany, traditionally the area's powerhouse, has become its laggard. The recent weakness of Germany's economy is partly due to temporary factors which should ease this year. However, demographic and structural headwinds, partly driven by global fragmentation, mean the economy is likely to grow by little more than 0.5% per year in the late 2020s. This is below its trend before the pandemic and lower than we expect in most major European economies. (See Chart 2.)

Outside of Germany, most euro-zone and Nordic economies will remain close to recession until the second half of this year, and the subsequent recoveries are likely to be gradual.

The UK, on the other hand, is a comparative bright spot. While its economy entered a mild technical recession at the end of 2023, recent activity data suggests the economy may already be out the other side. With inflation expected to fall, and remain, below 2% this year, this will give the Bank of England scope to cut interest rates by more than most expect, contributing to a relatively stronger economic recovery. (See Chart 2 again.)

Chart 2: GDP growth (y/y%)



Sources: Capital Economics and Refinitiv

While the near-term economic outlook for Europe is not without challenges, a lower-growth but broadly stable macro backdrop can actually be a benign environment for credit investors. Lenders are not looking for equity upside or relying on rapid economic growth to drive returns. Rather, they are seeking predictability of cash flows and to be repaid over time with minimal defaults. Indeed, strong economic growth often presents a risk of early repayment. So, while economic recoveries over the next year are expected to be muted, the return of a more stable outlook is a welcome development.

In-depth: Financial stability in a higher rates world

AI to lift potential growth & bring higher real rates

Interest rates have risen at their fastest pace since the late 1990s and to levels not seen since before the 2008 Global Financial Crisis (GFC). The recent rise – which has been caused partly by a structural rise in the real equilibrium interest rate and partly by a cyclical rise required to reduce inflation – has highlighted the age-old conflict between policymakers' objectives of hitting their inflation targets and maintaining financial stability.

Unsurprisingly, this has led to fears that the transition to higher rates would crystallise any financial imbalances built up during the years of ultra-low interest rates, that is, "break" something in the financial system and leave deep scars on economies. This may have been on policymakers' minds as they raised rates to reduce inflation back to target.

It appears that policymakers have managed this transition to a higher interest rate era well. Admittedly, there have been pockets of isolated and short-lived financial instability, such as the demise of the US bank SVB and the collapse of Credit Suisse. Those episodes, however, were all isolated, short-lived and didn't have a lasting influence on asset prices or the economy. This

may be partly because policymakers have an expanded toolkit to use to minimise risks.

Even so, it is probably too soon to sound the all-clear. But with rate cuts on the horizon, policymakers can relax a bit in the more immediate term. In other words, interest rates currently appear to be below levels that could cause problems for the financial system, and that favourable gap may soon grow.

What's more, the end of ultra-low interest rates and the start of a new higher rate era should help prevent new financial imbalances from building. After all, when rates are higher, many investors don't need to take as many risks in the "search for yield". This means new financial imbalances in systemically significant areas, such as housing, are less likely. Higher interest rates may be less effective, however, in preventing speculative behaviour elsewhere. A prime suspect could be the current wave of enthusiasm for Artificial Intelligence (AI) that has boosted US equity prices.

Generative AI would appear to have all the characteristics of a "general-purpose technology" (GPT), meaning it is likely to impact all sectors and businesses across economies. Past GPTs include the steam engine, the introduction of electricity and the ICT revolution.

Due to AI's wide-reaching nature, we expect advanced economies around the world to benefit from an AI-driven productivity uplift in the coming decade. To the extent that the ICT revolution is a good guide to what may occur, we anticipate a boost to annual productivity growth in economies that fully embrace AI in the region of 1.5% for a period of a decade or two.

The AI revolution is likely to add to upward pressure on real and nominal bond yields, but should also be a positive for stock markets. One reason is the prospect of even faster growth in earnings than in output. Another is that we think it will be accompanied by rising price/earnings multiples, as investors seek to crystallise upfront the benefits of a technology that are likely to diffuse only slowly through economies.

Implications for private credit

Mid-market is back as uncertainty begins to fade

The business environment over the last few years has been dominated by volatility from both economic and geopolitical factors. A confluence of crises – the global pandemic, the war in Ukraine, and the energy crunch – followed by surging inflation and ensuing monetary and fiscal tightening, meant that private equity investors faced considerable uncertainty heading into 2023.

Indeed global private equity deal value and volumes in the first half of 2023 fell to their lowest in at least five years. Yet after a slow start to the year, the second half of 2023 saw activity begin to pick up as the macro-economic backdrop started to develop some semblance of stability. This momentum has continued into early 2024, with European syndicated leveraged loan volumes rising to €29.3 billion in the first quarter of 2024, the busiest quarter since Q2 2021[1].

We're not out of the woods yet. The euro-zone economy will remain close to recession until the second half of the year and the subsequent recovery is likely to be weak. Yet, while economic conditions this year will remain challenging, there is significantly more certainty today than there was a year ago.

Stability is what allows buyers and sellers to price assets. Uncertainty makes the valuing of assets virtually impossible, which partly explains the drop in dealmaking activity last year. With so

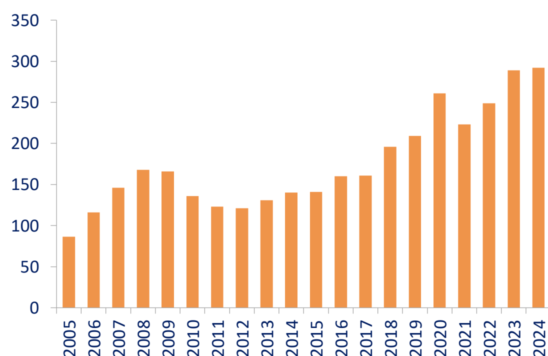
[1] Source: PitchBook | LCD Q1 2024 reporting

many sponsors preferring to hold on to existing assets rather than sell them at an undervalued price, the amount of capital sitting and waiting to be spent has continued to accumulate.

Dry powder for European-focused buyout funds has hit a record $292 billion as of April 2024[2]. (See Chart 3.) This capital needs to be spent, suggesting that there is a significant amount of M&A activity ready to take place in the right conditions.

The M&A pipeline appears to be warming up, and is expected to become more fluent from the half year mark as economic conditions become more favourable. With inflation decelerating towards central bank targets and interest rates cuts on the horizon, the significant backlog of assets that has piled up across investor's portfolios should hit the market in the months ahead.

Chart 3: Europe-focused private capital dry powder (US$ billion)



Source: Preqin. Note: 2024 value is YTD as of April 2024

Indeed, as the "higher for longer" monetary policy backdrop normalises, there is growing pressure on sponsors to monetise their portfolios, whether it be via sales or dividend recaps, and deploy their growing arsenal of dry powder. The gradual reopening of the IPO market in light of strong stock market valuations is also fuelling momentum for private equity firms to act on opportunities.

There has already been a flurry of activity at the start of this year, with private equity managing to sell businesses and strong activity in the secondary market as well. A stronger pipeline should see more transactions in the second half of the year, both for direct lending (private credit) and for the more liquid markets. While publicly available data tends to lag the situation on the ground, we are seeing very strong signs of this in our own direct lending activity, with a significant increase in new direct lending commitments in H1 2024 to date compared with the first half of 2023.

Improving market conditions are also helping to foster a return of true mid-market deals. If the story of 2023 was one of direct lending groups moving up the size spectrum to finance larger companies, we believe that 2024 will see a return to the mid-market as activity starts to normalise at all size levels. Again, the leading indicator of this is what we see in the market, with many companies with EBITDA of €20 million to €50 million seeking financing.

A note of caution though – despite a more benign outlook overall, competition remains intense for high quality assets – those with double digit growth, high levels of recurring revenue, high margins and dominant market positions. In light of this, strong sponsor relationships, speed of execution and transaction flexibility remain key to successful deployment.

[2] Source: Preqin as at 4 April 2024.

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