PERMIRA CREDIT MARKET UPDATE
Q4 2024

In partnership with Capital Economics

Please note that the views described herein represent those of Permira Credit and Capital Economics as at Q4 2024.

- **Economic activity across Europe should continue to grow modestly in the coming quarters, as falling inflation and interest rates support a mild recovery in consumer spending. The continued stickiness of euro-zone services inflation means that the ECB is likely to keep cutting interest rates only slowly**

- **We expect the likely imposition of US tariffs on imported goods to have a relatively small impact on the euro-zone as a whole, even though some countries would be more affected than others. Due to its lower exposure to US trade, the impact would be even smaller for the UK. There, we expect economic activity to pick up thanks to an increase in public spending**

- **The outlook for private credit in 2025 could take two paths – one characterised by falling interest rates and a more stable economic backdrop, which are expected to increase companies' debt service capacity, boost M&A activity and result in greater deployment – and the other by ongoing global geopolitical instability acting as a block to the M&A pipeline. Managers should be prepared for both in order to perform in the medium term**

Economic outlook

Europe's slow recovery to continue

Economic activity across Europe will continue to expand in the coming quarters, but at a slow pace. While real GDP in the euro-zone in 2024 Q3 grew by 0.4% on the quarter, its fastest rate since 2022 Q3, this was mainly driven by a large one-off increase in household consumption. In France, consumer spending was boosted by the Paris Olympics, and in Germany it rebounded after contracting in Q2. But with the latest surveys showing consumers will remain cautious, we expect the savings rate to decline only gradually as the ECB reduces interest rates. As a result, consumer spending growth will largely depend on real income growth, which we think will slow as nominal wage growth normalises and the labour market loosens.

The upshot is that we expect consumer spending to continue to grow only modestly in the coming quarters in most euro-zone countries. The outlook is a bit more positive in the Netherlands, where household debt is relatively elevated and consumers will benefit more from falling interest rates.

While the picture varies significantly at the country level, fiscal policy in the region as a whole will be tightened. France appears to be the main exception. The collapse of the government that intended to reduce the country's large budget deficit suggests that the next government is unlikely to have a strong mandate to tighten fiscal policy.

In all, we continue to expect the euro-zone economy to grow at a modest pace in the coming quarters, with GDP growth projected to average around 0.8% in 2024 and 2025.

Elsewhere in Europe, we expect economic activity to accelerate in the coming quarters on the back of growing consumer spending. This is especially true across the Nordics, as rising wage

growth and lower interest rates provide a boost to household disposable incomes. In the UK, economic activity will be supported by consumer spending growth, as well as a rise in public spending.

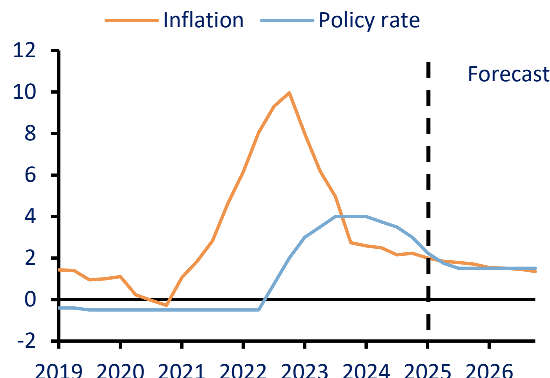
ECB to continue rate cuts in 2025

While headline inflation in the euro-zone increased in December 2024 from 2.2% in November to 2.4%, this was largely due to rising energy prices and was in line with consensus forecasts (see Chart 1). Most important for the monetary policy outlook is that core inflation was unchanged at 2.7% for the fourth consecutive month. Core goods inflation edged down from 0.6% to 0.5%, but services inflation ticked up from 3.9% to 4.0% – where it has now been stuck for just over a year.

This won't stop the ECB from cutting interest rates further. Energy inflation should fall back again in the first half of this year, and the high level of services inflation is partly due to temporary effects that should soon start to fade. Additionally, the recent loosening of the labour market should feed through to weaker wage growth in 2025, further easing price pressures.

But the fact that, for now at least, services inflation appears to be stuck around 4% means that ECB policymakers will tread carefully, preferring to cut in 25 basis point increments rather than moving more quickly. This is expected to bring the terminal rate down to 1.5% by September this year (see Chart 1).

Chart 1: Euro-zone headline inflation (y/y%) and policy rate (end of period %)



Sources: Capital Economics and LSEG Data and Analytics

Falling interest rates should support new bank lending. There are signs that lower interest rates have begun to support a gradual pick up in lending, with data from November 2024 showing that monthly net lending to households rose to its highest level since November 2022[1]. However, the big picture is that lending growth is still subdued.

The application of the Basel 3.1 standards began on 1 January 2025 across the EU, while it has been delayed by one year to 1 January 2026 in the UK. According to the latest "Basel III Monitoring Exercise" carried out by the European Banking Authority, minimum capital requirements for all banks are expected to rise by 7.8% from current levels. Even though tighter capital requirements could weigh on bank lending, the immediate impact should be limited as the full implementation of Basel III will occur over five years.

[1] Source: ECB as at 14 January 2025.

In-depth: US tariffs' impact on euro-zone should be limited

The incoming Trump administration's policies will likely have a mildly stagflationary impact on the US economy. Yet the impacts of Trump's policies will also have broader implications for economic activity outside of the US, particularly because US trade policy will become more protectionist. While the exact policies that will be implemented are still unclear, the imposition of a universal 10% tariff on all imported goods seems likely. Despite many headlines overstating its impact, we think such a tariff would have a limited effect on euro-zone economic activity, probably subtracting less than 0.2% from GDP. This is because exports to the US account only for small share of euro-zone activity. Also, higher tariffs will largely be offset by a stronger dollar vis-à-vis the euro.

Nonetheless, the impact of a 10% tariff would differ across countries with Ireland, Germany, Italy and a number of the Nordics the most vulnerable to a loss of US trade. France and Spain are significantly less exposed.

The euro-zone will remain strongly committed to the rules-based international trading system even if the US increasingly withdraws from it. This reflects the euro-zone's greater openness: the bloc's exports of goods and services amount to nearly 30% of its GDP, compared to just 11% to the US. This means that the euro-zone has more to lose from the world moving towards protectionism. However, one area where the EU may be forced to move in a more protectionist direction is in its relations to China. US coercion has already led to Europe cutting back on the sale of chip-making equipment to China and removing some Chinese components from its 5G network. The US may want to see further tightening of restrictions in these areas and potentially in the market for EVs.

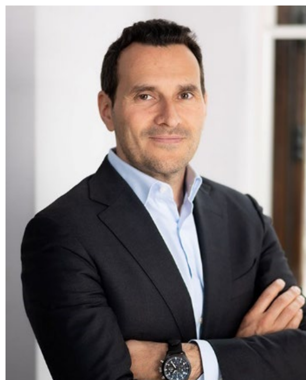
Latest Budget boosts short-term UK growth

Compared to the euro-zone, the UK is significantly less exposed to US import tariffs. This is because the UK exports more services to the US than goods, and services are likely to be exempt from tariffs. Moreover, a fall in the pound relative to the dollar as a result of the tariffs would cushion the rise in the prices of UK goods for US buyers.

More generally, we think economic activity in the UK will likely outperform that of most euro-zone countries. Although fiscal policy will still be tightened over the next five years, the measures included in the latest Budget represent a smaller tightening than the one in March 2024. And as lot of the rises in government spending kick-in immediately while the increases in taxes take longer to build, the boost to economic activity will be stronger in the short-term. The upshot is that we expect UK GDP to expand by 1.4% and 1.5%, respectively, in 2025 and 2026.

Confidential

Looking ahead to 2025 – Two possible paths: a Q&A with the Permira Credit team



David Hirschmann
Co-Head of Permira Credit,
Head of Private Credit

Ariadna Stefanescu
Co-Head of Permira Credit,
Head of Liquid Credit

Ian Jackson
Head of Strategic Opportunities

We sat down with David Hirschmann, Ariadna Stefanescu, and Ian Jackson to discuss what the macro outlook means for their various strategies.

The clear consensus was that we are faced with two possible paths this year – one characterised by falling rates helping to unblock the system and facilitating a boost in M&A activity, and the other by destabilisation and volatility caused by ongoing geopolitical risk.

Q: Interest rates are expected to gradually fall in 2025 in both the euro-zone and the UK – what does that mean for your business?

David: For direct lending, falling rates are generally a positive development. For companies without an interest rate hedging strategy, falling rates will lower their cash interest expense. This means a higher debt service capacity that mechanically improves their credit quality. The impact of falling rates is also positive for deal flow, as lower rates not only increase borrowing capacity for companies, but also for businesses that are looking to make acquisitions. 2024 was a recovery year after a weak 2023 and we expect this positive momentum to continue in 2025, supported by falling rates. So, this helps to create an environment where the volume of capital and the velocity of M&A activity both increase.

Q: What about the yield? Talk through how it gets affected by this fall in rates.

David: Yes, of course, the flipside of falling interest rates is that the yields go down. Direct lending still offers an attractive risk-adjusted return, though, despite that. It's also important to keep in mind that, other than the yield, investors are just as focused on the recycling of capital and distributions to paid-in capital (DPI). We also factor in the projected interest-rate environment for each new investment, ensuring any potential reduction in base rates is accounted for from the outset.

Q: Ian, let's bring you in to discuss the credit opportunities space. How do you see that developing?

Ian: Similar to direct lending, lower rates will have an impact on yields. But a key point here is that yields for transactions in strategic opportunities tend to be in the high teens. So even a 100-basis-point reduction in yields won't be overly impactful. Our market is for the most part driven by the supply and demand imbalance of available credit and the complexity of the opportunity rather than the actual level of rates. And, to echo what David said, what's particularly supportive for our outlook is that lower rates should unlock a great deal of M&A activity in 2025.

Q: Ari, talk to us about the broadly syndicated loan (BSL) market. What are the recent trends affecting the market?

Ari: The increase in interest rates over the past couple of years led to record levels of capital flowing into credit markets. In Europe, we had record new issuance of collateralised loan obligations (CLOs), which are the main buyers of BSL. But at the same time, we had a lack of new deal formation because of weak M&A activity. This led to a significant tightening in the secondary market and tighter pricing in new deals coming to market. Until we see a substantial pick-up in M&A activity, we don't see these trends reversing.

Q: What about bank appetite for risk – will that affect BSL activity?

Ari: Yes, it's certainly a key driver. And banks right now are very much "risk-on", as we're seeing more evidence that they're able to quickly sell the BSL they're underwriting to the institutional market. But to really satisfy that demand, M&A activity needs to pick-up and we think falling rates will help there.

Q: So to recap, the general theme seems to be that falling rates should "unblock" the system, encourage M&A activity, and that all means greater deployment. That seems the most likely path, but are there any risks to that view? Or anything that could take us down a different road?

Ian: The key risk for me is geopolitical. I see a lot of areas of volatility, with new risks emerging almost every week: Middle East, Ukraine-Russia, China-Taiwan, South Korea, Romania, Georgia – there are many. And high levels of uncertainty are not good for deal flow because it makes businesses want to delay decisions. But more generally, it's really a case of whether these geopolitical risks stay in the background or if they actually evolve into something bigger.

Q: What would happen then?

Ian: Well, it's hard to say at this point – it's really dependent on the event, but at best we could see a pause in M&A activity and at worst there would probably be some sort of "repricing" across several asset classes.

Q: Let's assume a "repricing" event does actually occur, talk about the implications for your specific strategies. And more broadly, how do the three of you leverage off each other in this kind of environment?

Ian: First of all, I would say that we are prepared for any eventuality. We have a strong brand name, which means the capital is there. And our global footprint means that we have good origination across geographies. This allows us to be selective about deals and make better informed decisions.

Ari: Also, we've got a long track record of investing in periods of market dislocation. So, even if increased volatility will lead to a decline in new BSL or CLO issuance, the secondary market would offer attractive

investment opportunities for all our strategies, whether Liquid Credit, Direct Lending or Strategic Opportunities.

David: Yes, and I'd just add that being able to tap into our wide set of expertise across a range of flexible credit solutions, as well as Permira's deep sector expertise on the PE side[2], is particularly valuable when there is uncertainty. So, for example, if the macro outlook for Europe seems less positive, we focus on anti-cyclical sectors that are less correlated with GDP growth and have their own momentum. I'd say this is why we've been able to consistently extract value – especially in periods of high volatility.

[2] Interaction between the investment teams for each of Permira Credit's strategies is managed within the parameters of Permira Credit's compliance policies and applicable confidentiality and regulatory requirements.

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