

From buzz to balance

Private credit faces challenges, but structural growth prospects remain solid

The buzz around private credit following the bankruptcy of First Brands demonstrates that investors need to be alert to the risks of engaging with this opaque market. But it is also important not to exaggerate the negatives around the credit risks or growth of this asset class or mix up different risk classes within this very heterogenous market segment.

Direct lending – as the core segment of private debt – does have challenges, including poor transparency, limited headroom for deleveraging and the rising importance of refinancing. But we remain constructive about the growth of direct lending and associated fundraising in Europe, which will likely push AuM of private debt in Europe to above EUR 500bn by the end of 2026.

Neither the challenging current sentiment (which we believe will be temporary), selected defaults, corporate restructurings nor the return of banks to syndicated lending (European volumes +24% at 9M 2025, the strongest since 2007, according to LSEG Deals Intelligence¹) are enough to jeopardise our constructive medium-term outlook for direct lending, which is driven by:

1. Appealing risk-return for investors,
2. A wider investor base and a shift in borrower focus to smaller middle-market corporates,
3. A high proportion of sponsor-driven activity and the high volume of dry powder at sponsors, which can provide equity or shareholder loans if needed,
4. A stabilisation of credit profiles amid interest-rate tapering and our outlook for continued economic growth, which is supportive for the sectors that dominate the direct lending landscape.

Structural demand for non-bank financing remains strong, especially among mid-market companies seeking flexible capital solutions. Investor appetite is also resilient, underpinned by the asset class's ability to deliver compelling risk-adjusted returns. The widening of the investor base through the emergence of retail fund exposure (via products such as ELTIFs), and the leveraging of direct lending strategies to new areas such as CLOs will likely fuel further growth of AuM.

Low-rated market segment

Based on a portfolio of about 50 European companies covered by Scope, the credit risk profile of direct lending borrowers is high: the average rating is in the B category. The Scope universe largely represents the typical sector split, with the strongest exposures in business and consumer services, TMT, healthcare and financial services.

The average credit profile is a natural consequence of the borrower universe: middle-market companies typically operating in market niches with highly leveraged balance sheets and ambitious debt-funded growth plans. Credit ratings are further constrained by lack of transparency inherent in this market segment around financial reporting, strategy and corporate governance.

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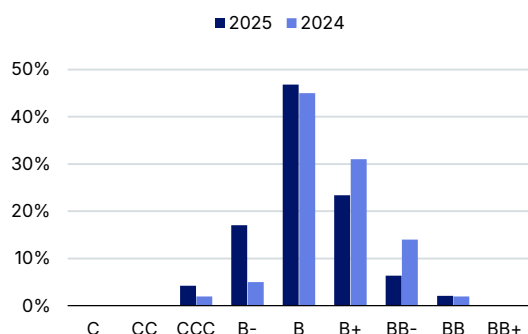
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Table of content

1. [Credit quality pressure eases with lower rates and margin compression](#)
2. [High leverage to persist amid ambitious M&A strategies](#)
3. [Refinancing surge to test resilience of direct lending borrowers](#)
4. [Exposure to multi-layered debt structures intensifies credit pressure](#)
5. [Continued economic growth supports stabilising credit profiles of direct lending borrowers beyond 2025](#)

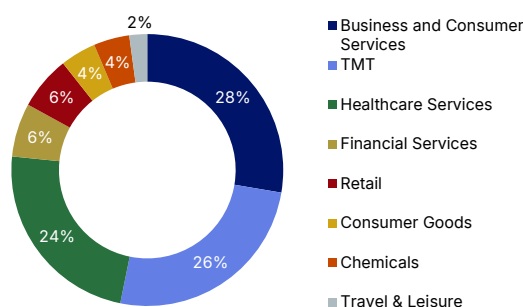
¹ LSEG Deals Intelligence: Global Syndicated loans. First Nine Months 2025

Figure 1: B ratings dominate credit ratings in direct lending*



* As signalled by Scope's rating exposure to European borrowers
Source: Scope Ratings based on 48 rated entities

Figure 2: Sector exposure of companies rated by Scope*



* exposure very similar to sector split of European borrowers
Source: Scope Ratings based on 48 rated entities

For the development of the market in 2026, we see five key points:

1. Credit quality pressure eases with lower rates and margin compression

We believe that the erosion of credit quality among companies relying on direct lending has bottomed out, supported by interest-rate tapering and its positive effect on interest coverage. Overall, we see a stabilisation or potentially a rebound in interest coverage, signalling a more benign environment for credit quality in the direct-lending segment. With borrowers primarily exposed to variable-rate debt, the decline in benchmark rates since summer 2024 is expected to lift average interest cover ratios from below 2x in 2023/2024 to 2x and above from this year.

Several factors underpin this outlook. First, lower interest rates directly reduce debt-servicing costs which, combined with improved operating performance, provides additional support to coverage metrics.

Second, competitive dynamics in the financing market are exerting downward pressure on interest margins, which benefits borrowers seeking new funding or refinancing. Banks, seeking to regain market share, have tightened spreads on broadly syndicated loans (BSL). Deals tracked by PitchBook | LCD signal a steady reduction of spreads on new deals from more than 600bp in 2023 to around 550bp in 2025².

Third, weaker companies are increasingly using PIK toggles to preserve liquidity and temporarily improve interest cover until their operating performance can better absorb the interest burden. While this is to the detriment of the lenders, they are prepared to accept it for the sake of more stable credit profiles.

Rebound of interest coverage supported by several items

Lower rates ease debt-servicing costs

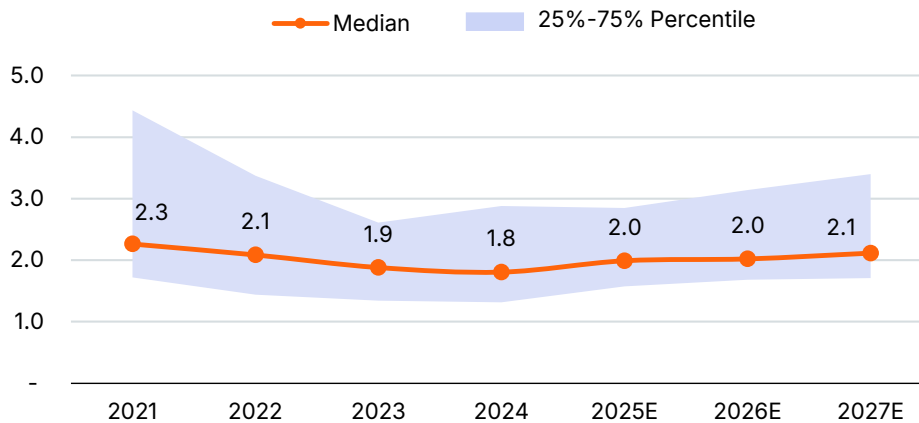
Competitive market pressures reduce credit spreads

PIK toggles preserve liquidity for the weakest companies

² PitchBook | LCD (4 April 2025): European private credit dealmaking ties quarterly record, but M&A underwhelms

Figure 3: Likely rebound in interest coverage

EBITDA to net cash interest of companies covered by Scope



Source: Scope Ratings based on 48 rated entities

2. High leverage to persist amid ambitious M&A strategies

European companies accessing direct lending are expected to maintain elevated leverage over the next two years, largely driven by a continuation of ambitious, debt-funded M&A strategies. Borrowers frequently tap direct lenders for incremental facilities to fund bolt-on deals, expand product lines, or pursue sector consolidation in fragmented industries.

Elevated leverage driven by debt-funded M&A

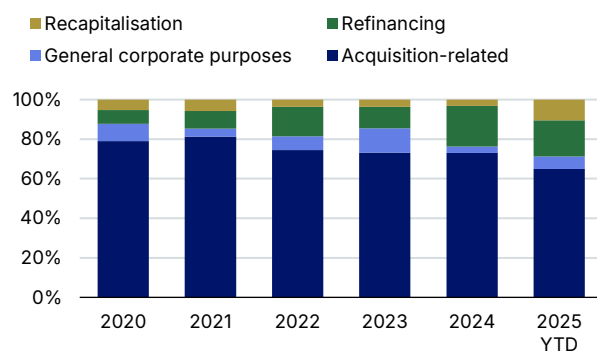
Even though M&A deal flow in Europe has reduced so far in 2025, acquisition financing still represents the largest use of proceeds. According to PitchBook, around 65% of direct lending proceeds to the end of October 2025 financed M&A transactions vs 70% to 80% in the previous five years.

M&A financing remains dominant use of proceeds

Opportunities to reduce leverage are limited, as borrowers continue to prioritise acquisitions. While this strategy supports scale and competitive positioning, it also locks in elevated leverage, increasing refinancing complexity and credit risk in a higher rate environment (although as stated above, lower interest rates will benefit this factor). Our company sample indicates average leverage (as measured by debt/EBITDA) will stay well above 6.0x, leaving little headroom for meaningful reduction and keeping ratings at a low level.

Limited deleveraging keeps credit risk high

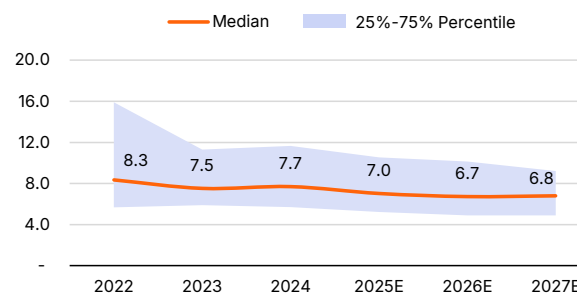
Figure 4: European direct lending deals by purpose



Source: Scope Ratings based on Pitchbook | LCD - data through 31 Oct 2025
- Analysis based on deal count where transactions were covered by LCD News

Figure 5: Leverage likely to stay at elevated levels

Debt/EBITDA of companies covered by Scope



Source: Scope Ratings based on 48 rated entities

3. Refinancing surge to test resilience of direct lending borrowers

Refinancing is set to become a major challenge for European companies that rely on direct lending, as volumes are expected to rise sharply compared to recent years. This surge reflects the wave of deals originated since 2020, which significantly outpaced pre-2020 activity and which approaches maturity in 2026 and beyond. We see most activity coming in the form of refinancing bullet maturities, as amortising structures are rare given that bullet facilities better serve the needs of borrowers and fit the investment horizon of lenders.

Increasing exposure to refinancing needs

For credits covered by Scope, refinancing risk represents the most significant vulnerability, even though actual cases of financial restructuring so far are rare. However, several factors will help mitigate these risks:

Refinancing pressure mitigated to some extent

1. Improving confidence in business models and operating performance should make it easier to structure refinancing rounds, particularly as economic conditions stabilise.
2. The dominance of sponsor-backed companies in the direct lending landscape provides flexibility through amend-and-extend solutions or additional equity support.
3. Significant dry powder, which Pitchbook | LCD estimates at more than 30% of total AuM, may help provide bridge financing to companies facing liquidity crunches at the time of refinancing.
4. A resumption of activity in the broadly syndicated loan market and recapitalisation options linked to sponsor exits offer alternative pathways for refinancing. While the environment will remain demanding, given higher interest costs and competitive dynamics, the combination of stronger fundamentals, sponsor support, and diversified refinancing channels should prevent widespread distress, though proactive management will be essential.

4. Exposure to multi-layered debt structures intensifies credit pressure

Multi-layered capital stacks amplify refinancing risk and elevate credit vulnerability. Companies using direct lending face heightened credit pressure when exposed to multi-tiered financing structures spanning operating (OpCo), intermediate (MidCo/BidCo), and top holding (TopCo) levels. While OpCo debt typically consists of senior secured loans or unitranche facilities, MidCo and TopCo layers often include subordinated or PIK instruments that defer cash interest but may steadily increase leverage of the group.

Layered capital structures heighten risk

This layered approach creates complex repayment obligations that need to be taken into account in companies' credit profiles, as operating cash flows ultimately need to support all levels of debt, even when some payments are deferred. The result is a persistent strain on liquidity and limited flexibility for deleveraging. Refinancing these structures adds further complexity, given competing priorities among lenders and intricate intercreditor agreements.

Group debt servicing obligations could constrain financial flexibility

5. Continued economic growth supports stabilising credit profiles of direct lending borrowers beyond 2025

While elevated geopolitical tensions, deeper political polarisation and persistent fiscal challenges outweigh the potential for stronger growth and fiscal resilience among certain European sovereigns, GDP growth forecasts remain supportive.

We expect European companies relying on direct lending to see stabilising credit profiles as operating results gradually improve beyond 2025. The past two years have been marked by pressure on margins and cash flows due to persistent inflation and constrained consumer and industrial spending, particularly impacting sectors such as business and consumer services, TMT (primarily technology), financial services, and consumer products; segments that together represent nearly 70% of the direct lending borrower universe.

Economic growth to support operating performance in relevant sectors

Scope is forecasting continued GDP growth in 2026 of around 1.3% in the euro area and 1.0% in the UK³, following three years of sluggish annual expansion averaging less than 1%. This should underpin revenue growth and margin stabilisation/improvements and help restore operating leverage, enabling companies to absorb financing costs and remain compliant with covenants.

Moderate GDP growth supports recovery of credit metrics

For lenders, improved earnings visibility and stabilising or improving credit metrics will likely provide more comfort for co-ordinating refinancing, particularly for businesses with resilient demand profiles and scalable cost structures. While near-term challenges remain, the combination of easing inflationary pressures and moderate GDP growth provides a foundation for credit stabilisation, reinforcing the attractiveness of direct lending as a financing tool for mid-market European corporates.

Operating recovery supports refinancing wave

³ [Scope Ratings \(26 Nov 2025\): Scope Ratings Sovereign Outlook 2026](#)

Related research

[Sovereign Outlook 2026: geopolitical tensions, fiscal headwinds outweigh growth, resilience](#), November 2025

[Private credit: singular risks but also opportunities for Europe with capital-markets reform](#), October 2025

[European direct lending: credit metrics strained but negative ratings migration likely to ease](#), August 2024

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