European direct lending: credit metrics strained but negative ratings migration likely to ease

Growth in AuM to slow pending pick-up in economic and investment outlook

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Direct lending as a subset of Private debt

Direct lending has emerged as a crucial funding channel for mid-market companies, particularly those that follow debt-funded buy-and-build growth strategies. It has seen significant growth over the past 10 years, primarily due to a search for yield by lenders and investors in the low-interest-rate environment. Assets under management of debt fund managers focused on lending to European companies has reached USD 400bn, although we expect growth to continue at a slower pace than in the past 10-years (CAGR of AuM of 17%), at least until the current constraints on economic growth and investment (such as higher-for-longer interest rates) are outweighed by supporting factors.

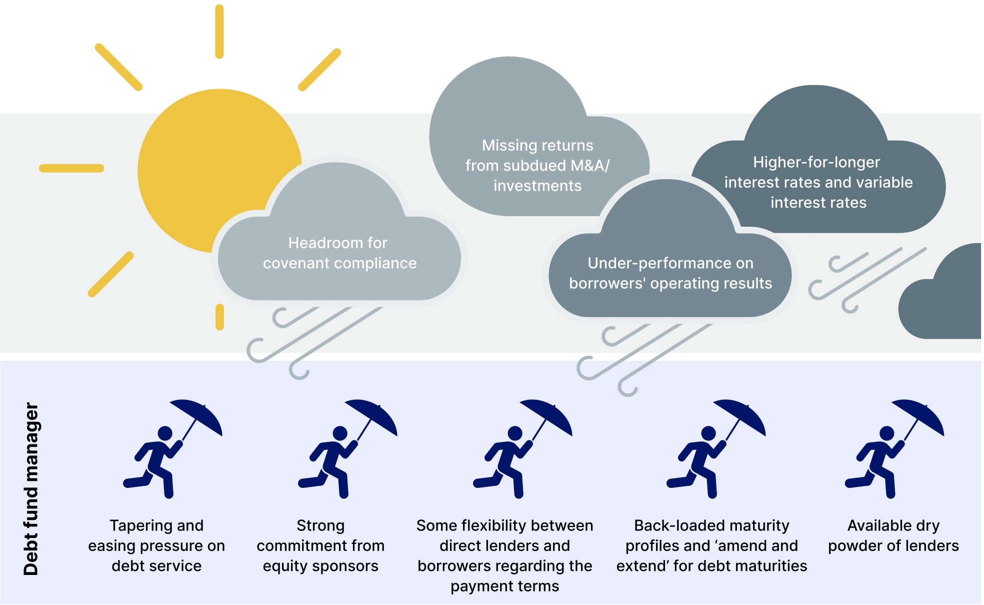
Navigating stormy weather: resilience and flexibility in direct lending mitigate increased default risk

Based on our coverage of the direct lending exposures of different debt fund managers, we have observed credit challenges as well as risk-mitigating factors. In particular, exposure to variable interest rates is a double-edged sword. Given the moderate to weak credit profiles of borrowers, typically ranging in the low B to mid BB rating categories, thorough credit analysis and due diligence are necessary to assess and monitor the creditworthiness of borrowers.

While the average credit profile of covered entities has deteriorated over the last 24 months, the picture is improving. Weaker credit profiles have primarily been driven by the impact of variable interest rates, weaker-than-expected operating performance, subdued returns from reduced investment activity, and delayed deleveraging.

We believe the erosion of credit quality has bottomed out in light of interest-rate tapering and easing concerns about economic growth, while higher default risk can be mitigated by an array of measures provided by equity sponsors and direct lenders.

Figure 1: Direct lenders shielded from stormy weather


Missing returns from subdued M&A/ investments
Higher-for-longer interest rates and variable interest rates
Headroom for covenant compliance
Under-performance on borrowers' operating results
Debt fund manager
Tapering and easing pressure on debt service
Strong commitment from equity sponsors
Some flexibility between direct lenders and borrowers regarding the payment terms
Back-loaded maturity profiles and 'amend and extend' for debt maturities
Available dry powder of lenders

Source: Scope

Scope's rating activities: clear signals of strained credit quality, but rating pressure is likely easing

Scope has provided credit assessments for around 100 entities

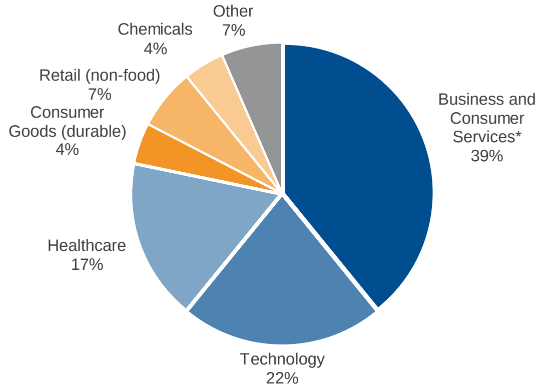
As of today, Scope has provided 70 private ratings – either monitored or as point-in-time assessments – as well as 24 point-in-time credit estimates[1] on different borrowers that use direct lending. Over the last 24 months, we have rated an aggregated loan exposure of more than EUR 5.6bn. Issuer ratings are largely concentrated in the B category (Figure 3). Credit assessments are at the issuer level and typically on defined debt positions held by the lenders, primarily first-lien senior secured or unitranche loans, the latter reflecting Scope's expectations of a recovery rate in the hypothetical case of a default.

Rated debt is typically rated up to two notches higher, but also in rare instances one notch lower than the issuer rating (average of 0.8 notches above the issuer rating in our coverage). Average up-notching is limited, however, even though rated debt positions are typically secured and benefit from a pledge of all assets not pledged to other debt positions. This is related to the often asset-light nature and modest competitive positions of rated mid-market companies, which limit the expected value of claims in a liquidation or distressed sale of the rated company as a going concern.

Representative sample concentrated in business and consumer services, software and healthcare

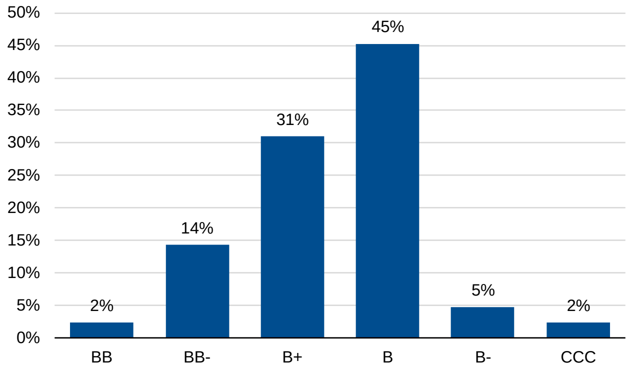
Our coverage is a representative sample of the market when considering sector allocations and rating levels (Figures 2 and 3). Similar to the general industry concentration for direct lending in Europe (Figure 10), rated entities are concentrated in business and consumer services, technology (mostly software and IT services) and healthcare, hence our rated portfolio is geared towards these three dominant sectors. Our ratings are all sub-investment-grade and represent a wide range of mid-market corporates with average annual EBITDA of between EUR 10m and EUR 50m. Larger middle-market corporates (recurring EBITDA of more than EUR 100m) are rare exceptions, as are very small corporates or Annual Recurring Revenue-driven (ARR)[2] deals.

Figure 2: Sector exposure
Measured by number of ratings for companies with direct lending exposure rated by Scope



Source: Scope
* includes Financial Services such as agency services and brokerage companies

Figure 3: Rating distribution
Measured by number of ratings for companies with direct lending exposure rated by Scope



Source: Scope

Credit erosion amid direct lending challenges ...

Our sample offers good insights into direct lending borrowers on various fronts. What is most striking is the ratings migration i.e. comparing the last rating action with the previous action. While around half of the ratings in our coverage could have been maintained or reflect ratings upside, the other half shows ratings erosion, either through actual downgrades/lower point-in time ratings

[1] Scope's Credit Estimates are point in time by nature and approximate assessments of credit quality of an Issuer based on the analysis of public or private information provided by the party initiating the request. They are expressed either in broad rating category terms (i.e. without '+' or '-') or with a range of notches and are carried out with less detailed data requirements than Credit Ratings.

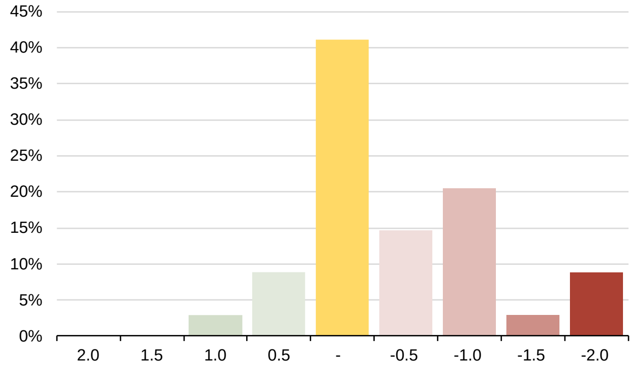
[2] Annual Recurring Revenue: financings of companies that demonstrate a track record of solid recurring revenues but which are yet to mature into positive-EBITDA generating businesses.

or weakened Outlooks (Figure 4). Rating pressure is particularly evident for business services and technology companies whose operating performance could not offset the rising exposure to debt and interest increases.

... but no reason to panic

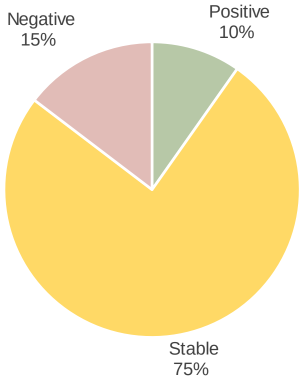
However, this does not point to widespread and permanent credit erosion. When looking at Outlook distributions (Figure 5), a large part of the negative credit migration has already been reflected and credit erosion is likely to slow.

Figure 4: LTM rating migration
Measured by notches* compared to the previous rating



Source: Scope
* One-notch rating difference = ±1; weakened/strengthened Outlook = ±0.5

Figure 5: Outlook distribution (on the latest rating*)
Measured by number of ratings for companies with direct lending exposure rated by Scope



Source: Scope
* Includes rating Outlooks for point-in-time ratings

Manifold strains on credit quality

A number of trends have resulted in negative rating actions or are likely to put further strain on rated companies' credit profiles:

First and foremost, we have seen more pressure on important credit metrics that are expected to deteriorate significantly (e.g. interest cover) or which we can no longer expect to improve quickly (e.g. leverage).

Deterioration of interest cover amid largely unhedged higher-for-longer interest-rate exposure

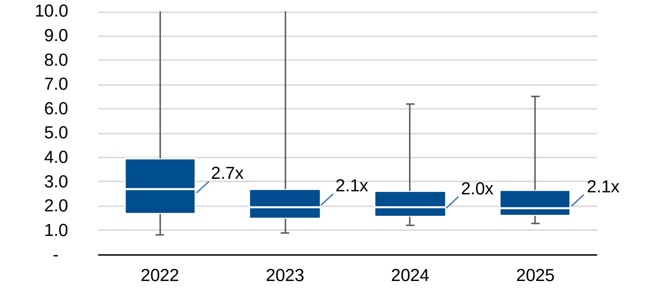
Variable-rate exposure has taken its toll. While the variable-rate debt structure is great for lenders, **higher-for-longer interest rates are putting increasing pressure on debt service** and bite into the liquidity of borrowers that cannot pass on higher funding costs to their customers. Middle-market companies tend not to hedge their interest-rate risk but even if they start to do so, it is too late. While median interest cover (EBITDA/net interest paid) stood at a range of 2.7x to 2.1x in 2022/2023, our projections for the same entities in 2024/2025 stand at a median of 2.0x-2.1x (Figure 6). While this is still comfortable at an aggregate level, around one in four rated entities have cover ratios of just 1.5x, which does not offer much headroom for a robust debt serviceability.

Subdued deleveraging potential

Similar, but less problematic, is the **slower-than-expected pace of deleveraging** (Figure 7). Rated entities are likely to maintain high median leverage levels: 7.4x as measured by Scope-adjusted debt/EBITDA for 2023, followed by only gradual deleveraging to a median of 6.8x in 2024 and 5.8x in 2025E. A quarter of rated entities still show leverage of more than 7.0x at YE 2025E, however. Deleveraging prospects are primarily driven by expected improvements in operating performance, reduced interest payments and returns from business expansion via M&A. However, we expect deleveraging to happen at a slower pace compared to a year ago as a function of:

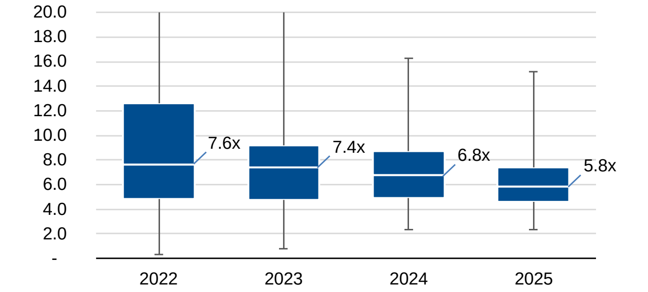
- Lower potential for debt reduction from weakening operating cash flow,
- Limited room for debt reduction due to ongoing debt-funded acquisitions or
- Subdued investment returns from acquisitions.

Figure 6: Pressure on interest cover
Scope-adjusted EBITDA/net interest paid for the rated portfolio



Source: Scope

Figure 7: Slow deleveraging
Scope-adjusted debt/EBITDA for the rated portfolio



Source: Scope

Note: We strip out 2021 actuals and 2026E estimates. 2021 statistics are distorted through a pre-money situation. For 2026E we don't yet have sufficient data points.

Operating performance below expectations amid challenging macroeconomic conditions

A significant share of **borrowers cannot meet expectations of operating performance** as it remains difficult for them to cope with the more sluggish macroeconomic environment, which means sustained cost increases, weakened demand, and margin dilution from acquired entities. Unless they have a very strong niche market positions , rated mid-market companies typically lack the pricing power to quickly pass on higher operating costs to customers. Hence, they need time to adapt to the more challenging environment and to implement cost savings programmes before operating performance and credit metrics can be restored or improved.

Limited execution of debt-funded investments weigh on the balance sheet

Likewise, **ambitious growth plans driven by M&A and organic investment** that were expected to be supported by new debt funding from direct lenders could not and **still cannot be executed as initially planned given the higher hurdle rates**. As a result, the expected returns from such growth strategies have not materialised and provided the expected return on investment, while the interest costs from dedicated funding are weighing on credit metrics.

Reduced headroom on covenants

The above makes it difficult for some rated entities to fully **comply with debt covenants** when buffer-to-covenant thresholds were already narrow during the 'golden years' before the mix of more challenging conditions unfolded. Actual or likely covenant breaches require lot of attention from debt fund managers, capacity which might be needed elsewhere.

Increased default risk likely to be contained

Despite the negative ratings pressure, default risk is less pronounced and will likely be contained owing to a number of factors.

Variable interest exposure also easing the pressure after tapering

First, because of our expectations for an **improving picture after 2024**. Base rates are expected to taper in coming months hence, the general **pressure on interest cover will likely bottom out or even reverse**, providing relief on debt servicing capacity. Investment activity is likely to resume, with the return from **new investments providing support to cash flows and credit metrics**.

Second, companies will gradually **adapt to the altered business environment** through cost savings programmes, restructurings or simple adjustments to pricing and procurement policies.

Proactive bilateral amendments of the loan T&Cs

Third, there is **greater flexibility between direct lenders and borrowers regarding payment terms** compared to more traditional financing, such as with banks or groups of professional investors. Borrowers can implement proactive bilateral amendments of terms and conditions, such as temporary or prolonged agreement of PIK interest recognition, if needed. This makes it easier for companies that use direct loans compared to those that issue high-yield bonds or have bank financing. We have only witnessed very rare cases so far in which such flexibility was needed, and borrowers and lenders have agreed on appropriate measures.

Some flexibility on maturity profiles

Fourth, borrowers typically benefit from **back-loaded maturity profiles and some flexibility to roll over debt maturities** well in advance of their original terms if debt coverage is obviously at risk, something we have already witnessed in our portfolio of covered entities. While the rolling of debt is similar to the typical 'amend and extend' process of banks, we believe that amendments agreed with direct lenders are significantly leaner, take less time and happen much more in advance given the close ties between direct lender and borrower.

Such flexibility puts borrowers in a favourable position compared to corporates that have to deal with rigidly defined debt maturities such as capital market debt or similar debt instruments from private placements when facing financial stress and refinancing pressure. Consequently, we believe there is lower risk of a hard default as maturities will likely be pushed out well in advance, unless there is no hope for a recovery in a borrower's debt servicing capacity, and insolvency following a winding up and debt recovery needs to be enforced.

Advantages for corporates with an equity sponsor

Fifth, the **commitment from equity sponsors** is a key factor. This supports borrowers in two ways, First, equity sponsors tend to support portfolio companies during more challenging times through equity injections, which provide immediate help. Moreover, a large share of borrowers have exposure to shareholder loans[3], which can be fully or partially converted into equity or carry PIK interest for some time. This could strengthen the affected company's balance sheet thereby easing the pressure on credit erosion or even default risk. As such, companies with a strong and committed equity sponsors have better chances of weathering temporary or extended challenging times.

Finally, **lenders' significant dry powder**[4], which we estimate at 20%-30% of total AuM, which can help provide bridge financing to companies that are likely to struggle for a temporary period. Additional temporary pressure on credit assessments can be digested, but the capacity needed in case of an insolvency and wind up/liquidation of a borrower would be much more onerous than providing temporary financial support in case there is good hope of an operational recovery.

The rise of direct lending (segment challenges and tailwinds)

Opaque nature of private debt

Due to the opaque nature of the private debt segment and given the various definitions of direct lending, standardised quantitative data about European direct lending to non-financial corporates is unavailable. However, the historical trends in fundraising and lending activities are unanimous and testify to a steep increase of fundraising and deal volume over the last 10 years. As such, direct lending has gained a pivotal role in supporting the growth of mid-market companies.

European direct lending AuM at a CAGR of 17% since 2013

According to data provider Preqin, assets under management with a focus on direct lending to Europe-based companies stood at around USD 400bn at YE 2023 (Figure 8). While this signals a steep growth trajectory (CAGR 10years: 17%), AuM in Europe remains significantly lower than volumes in the US where direct lending took off well before the global financial crisis and has become a widely used – if not commoditised – funding strategy.

European direct lending market lagging the well-established US market

The slower development of direct lending in Europe is primarily associated with i) the still-significant regional and local banking sectors in most European markets where bank financing is the most common funding channel for mid-market companies, and ii) the non-harmonised environment across European markets where local knowledge about insolvency law and lending terms is crucial for debt fund managers.

Direct lending particularly for SMEs with high-growth ambitions

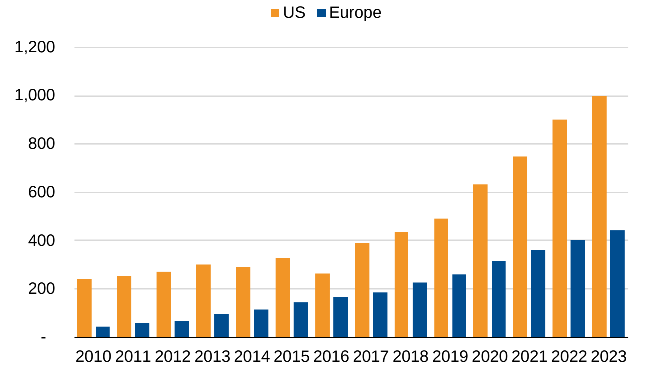
Nonetheless, direct lending has evolved from a niche market to a significant funding channel for SMEs, for which traditional bank financing has steadily been substituted by debt funds (Figure 9).

[3] Scope typically includes shareholder loans to 100% in the computation of leverage metrics, unless shareholder loans exhibit features that qualify for the provision of an equity credit, such as interest deferral at the discretion of the borrower and very long or non-defined tenors.

[4] Dry powder refers to the capital committed to the asset class but not yet unallocated.

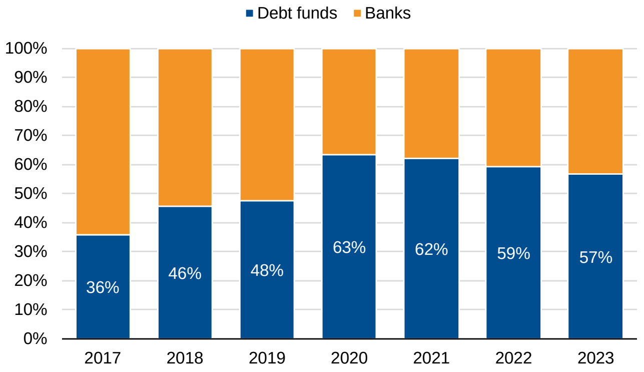
In particular, we see the usage of direct lending for SMEs with high growth prospects, either bolstered through M&A or through exposure to high-growth segments. In addition, the funding channel is frequently tapped in the case of corporate successions and recapitalisations.

Figure 8: Strong fundraising and sharp increase of debt fund volumes focussing on private credit*
Assets under management in USD bn



Source: Preqin, Scope
* includes direct lending, distressed debt, special situations debt, venture debt but with the largest exposure geared towards direct lending

Figure 9: Bank lending vs private debt to SMEs in Europe
Based on number of deals for pan-European PE-sponsored debt financing in major markets*

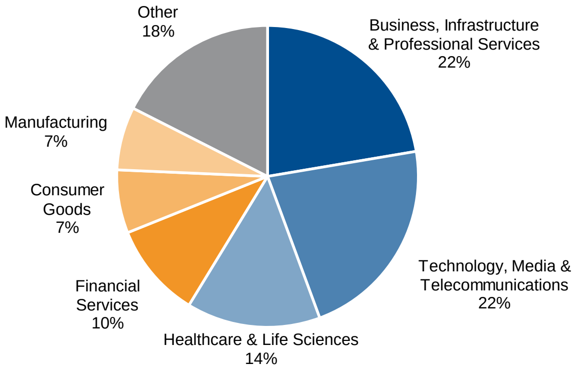


Source: Houlihan Lokey MidCap Monitor, Scope calculations
* DACH, France, Nordics, UK, Benelux

Sector concentration in asset-light industries

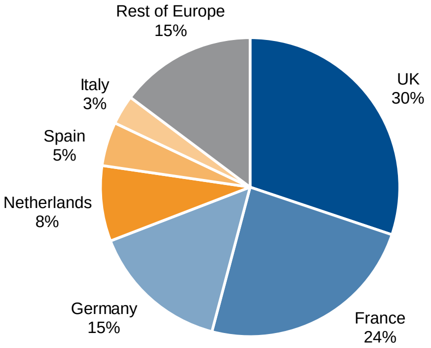
Direct lending activities are concentrated across three industries. Roughly 60% of deal allocation is to business and consumer services, TMT (primarily technology/software and IT services) and healthcare companies (Figure 10). From our perspective, this is a function both of the fragmented market structure and the general nature of mid-market companies concentrated in these sectors and consequently the pool for deal sourcing, and lenders' perceptions of resilient and cash-generative sectors. Companies in other capital-intensive sectors, such as asset-rich sectors like infrastructure, real estate, transportation or telecoms, have developed other funding channels such as asset-backed finance. Hence, they are under-represented in direct lending.

Figure 10: Sectoral deal allocation in Europe (2021-2023)
Measured by number of deals



Source: Deloitte – Private Debt Deal Tracker, Spring 2024; Scope calculations

Figure 11: Regional deal allocation in Europe (2021-2023)
Measured by number of deals



Source: Deloitte – Private Debt Deal Tracker, Spring 2024; Scope calculations

Tailwinds are still supporting further growth …

European direct lending activities are concentrated in the UK, France and Germany which make up roughly 70% of deals (Figure 11). It is not surprising that the most active European direct lending market is the UK given its similarities to the US market. We believe that direct lending in other European markets will catch up.

… but at a slower pace

While the strong growth of direct lending over the past decade has been supported by a wide array of factors, we do not believe recently emerging headwinds are strong enough to stop the growth in fundraising and deal allocation. We expect direct lending activities in Europe to continue to grow, albeit at a slower pace than the average annual debt fund-raising of around USD 40bn over the last five years. Figure 12 provides our overview of the most essential growth drivers and constraints over the next few years.

Figure 12: Supportive and constraining factors for the further growth of direct lending activities

+	-
+ Continued reduction in mid-market and lower-mid-market lending by banks (de-banking)	– An interest-rate environment that: – reduces M&A deal flow following higher hurdle rates – reduces the pool of eligible borrowers that can afford funding via direct lending channels (e.g. higher base rates plus potentially higher spreads) – channels funds to other – more liquid – asset classes that can also provide sufficient returns with better risk profiles
+ General appeal of direct lending for borrowers, e.g. the benefits of negotiating with just one lender and potentially an equity sponsor in unitranche deals (instead of multiple lenders in syndicated transactions)	– Return of banks to syndicated loans and lending to upper-middle market companies with solid credit profiles
+ Positive impact from the Alternative Investment Fund Managers Directive (AIFMD) II, which has established common rules for loan-originating alternative investment funds	– Increasing regulatory scrutiny for non-bank lending, e.g. tightening rules governing the activities of loan-originating funds "to alleviate risks to financial stability to ensure and ensure an appropriate level of investor protection".
+ Continued fundraising from institutional investors and the gradual opening of fundraising from retail investors who are attracted by the features of resilience, diversification, variable interest-rate exposure and below-average defaults	– Higher attention required for direct lenders regarding the monitoring of their credit portfolios, particularly for borrowers that are struggling with the sluggish macroeconomic environment and variable interest-rate exposure, thereby reducing the focus on deal origination
+ Expansion of the asset class to + Under-developed geographies, such as Iberia, Italy and CEE + Under-represented sectors + low middle market companies and ARR-driven deals	– Consolidation among direct lenders with fewer market entrants and some direct lenders reducing their exposure or even exiting the debt segment
+ Significant 'dry powder' of lenders that need to allocate capital	

Source: Scope

Direct lending as a subset of Private debt

Private debt refers to a form of lending outside of the traditional banking system. It is a complex and opaque asset class, featuring several sub-categories. As such, it is difficult to form a clear delineation against other debt class and to obtain fully accurate and complete data.

Within private debt, we distinguish between direct lending, distressed debt, special situations, mezzanine debt[5] to middle market companies and asset-backed lending such as for real estate and infrastructure[6]. Credit is provided directly by private credit/debt funds which are typically specialised by debt class, geography and/or industry.

Direct lending is distinct from leveraged loans or broadly syndicated loans, which are originated by a syndicate of banks and provided to typically larger companies than middle market companies that use direct lending.

Direct lending is by far the dominant segment within private credit (above 50% of total funds raised in 2023 according to leading data provider Preqin), and it relates to privately-placed debt directly negotiated between a borrower and a lender (typically a so-called business development company that manages several debt funds). In most cases (around 75%), borrowers are sponsor-backed companies. For this reason, direct lending is often referred to 'sponsor-backed lending'. Loans are typically provided with floating-rate interest and a wide set of financial covenants.

While loans provided under direct lending strategies are typically extended to companies with a high-yield credit profile, downside risk is mitigated by senior lien positions and collateral. However, unlike in asset-based finance and specialty finance, collateral is not related to specific cash generating assets but rather through a pledge on total assets which are not pledged to any other debt positions (general cession).

In addition, lenders gain control if a business defaults. The lender in this case can take control of the business to ensure repayment, having negotiated bespoke legal documentation with strong rights and controls, on a loan-by-loan basis.

[5] Containing various other niches as subsets such as venture debt, parallel lending.

[6] Other non-bank lending against pools of cash-flowing assets or receivables, e.g. auto loans, royalty payments.

Related research

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Europe faces further rise in corporate defaults: insolvencies to plateau only late 2024, early 2025, October 2023

Assessing the credit risk of direct lending funds, February 2020

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