iCapital

Private Credit: An Alternative Financing Solution for Europe's SMEs

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As traditional banks have receded from lending to small and medium-sized enterprises (SMEs) in Europe and higher interest rates continue to constrain financing options, private credit managers have an opportunity to fill the lending demand and support the backbone of Europe's economy.

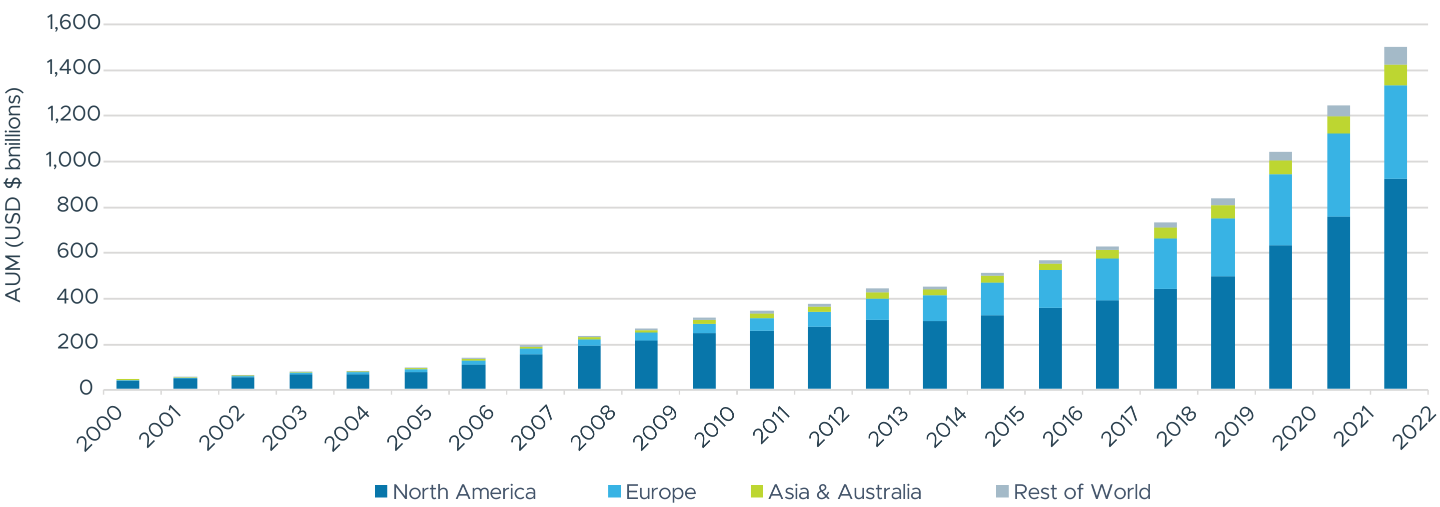
Following the Global Financial Crisis (GFC), bank participation in lending dropped precipitously due to stricter regulatory requirements. In the European Union, regulations such as Basel III increased the minimum amount banks were required to hold in liquid assets, leaving banks less inclined to underwrite smaller, less-liquid credit. This created a massive financing gap, particularly for SMEs. Bank lending in Europe has declined by an estimated $2 trillion since the financial crisis;[1] and the Brexit referendum in June of 2016 further reduced available lending capital. Moreover, stress in the banking sector in the first half of 2023 exacerbated the already constrained credit environment, as many banks constricted their lending policies.

The steep rise in interest rates in 2022 and the first half of 2023 also curtailed lending to SMEs in Europe. In an effort to curb inflation, the European Central Bank (ECB) deposit rate reached a record high of 4% in September 2023, a stark contrast from 0% in July of 2022.[2] Banks are more discerning in the current environment, causing lending supply to shrink, and making it even more difficult for companies to secure financing from bank lenders. While many believe this is the last rate hike of the year, it is anticipated that the 4% deposit rate will remain in place until at least July of 2024.[3] Back in June of this year, ECB Chief Economist Philip Lane stated he did not anticipate the deposit rate dropping back towards 2% for a couple of years, signaling this high rate environment is, at least in the near term, here to stay.[4] With the retreat of traditional banks, there is an opportunity for private credit managers to step in to fill the void.

It is estimated that there are approximately 25 million SMEs in Europe, representing over 99% of the businesses in the EU.[5] SMEs account for more than half of Europe's GDP

Exhibit 1: Global Private Credit

Assets Under Management (AUM)



Source: Preqin, as of Sept. 28, 2023. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

and employ nearly 100 million people.[6] The European Commission notes that access to financing is one of the most pressing issues for SMEs.[7] Given the bond financing market in Europe generally is not accessible to small and medium-sized firms, SMEs are more exposed to shocks to the banking sector and are in need of diversifying sources of capital.

The global private credit market has grown exponentially over the past two decades, including in the European Union. Yet of the $1.5 trillion of global private credit assets under management in 2022, only $400 billion were European-based,[8] demonstrating the opportunity in the region to gain higher market share.

Moreover, private credit presents an attractive opportunity for investors, offering enhanced income potential, diversification benefits, and access to an array of investment not available in the public markets. Historically, private credit has generated higher yields than most other public fixed income strategies.[9] Experienced and disciplined private credit managers are typically able to achieve strong downside protection because the privately negotiated nature of their transactions permits them to conduct extensive due diligence on potential borrowers and secure attractive covenants. These covenants (or conditions imposed by the lender to help protect against potential downside), in addition to proactive monitoring of a borrower's financial performance, allow private credit lenders to identify potential issues early on and work with management teams to address those issues before they hinder the company's ability to pay off its interest and debt obligations.

In addition, private credit financing is typically offered with interest payments at a spread above a floating reference rate, which moves in lockstep with the rate increases we have witnessed over the past 18 months. This floating rate structure mitigates interest-rate risk for investors and provides protection in an inflationary environment.

Despite the potential benefits of this alternative asset class, individual investors have faced significant headwinds in incorporating alternative investment strategies into their portfolios, including a lack of education, high investment minimums, and limited access to high-quality funds. Moreover, the investment process has historically been cumbersome and time-consuming, further deterring individual investors from pursuing these strategies. According to Bain & Company, individual investors held roughly half of global wealth ($140–150T) in 2022, with a nearly equal amount being held and managed by institutional investors ($135–145T).[10] Yet for individual investors, alternative investment strategies account for a very small percentage of their investable assets (estimated at less than 5%).[11]

For too long, individual investors have lacked efficient access to private market investments. Today, fintech platforms such as iCapital are changing this dynamic, with the goal of supporting wealth and asset managers in overcoming historical barriers. These platforms are leveraging technology to provide eligible investors with access to high-quality private market funds at lower minimums and to streamline the associated subscription process and administration burden. For asset managers, platforms like iCapital aggregate individual investor commitments into feeder funds at lower minimums, while allowing the fund manager to deal with a single entity, just as they would a typical institutional investor. Some of these platforms also provide education and fully transparent, institutional-quality due diligence, a service that has historically only been available to institutional investors.

As the high interest rate environment inhibits bank lending in Europe to SMEs, there is a significant opportunity for private lenders to step in to fill the void. Platforms like iCapital are facilitating access to these types of investment strategies, allowing individual investors to access private credit investments that can support SMEs within Europe seeking financing in a challenging credit environment.

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ENDNOTES

1. Blackrock, Private Credit: Evolution and Opportunity in Direct Lending, April 2022.
2. European Central Bank, Key ECB Interest Rates, as of Sept. 20, 2023.
3. Reuters, ECB Done Hiking Rates But Cut Not Expected Until at Least July, as of Sept. 19, 2023.
4. CNBC, ECB Chief Economists Warns Markets Against Pricing In Rate Cuts Within the Next Two Years, June 28, 2023.
5. European Commission, Internal Market, Industry, Entrepreneurship and SMEs, Sept. 27, 2023.
6. European Commission, Internal Market, Industry, Entrepreneurship and SMEs, Sept. 27, 2023.
7. European Commission, Internal Market, Industry, Entrepreneurship and SMEs, Sept. 27, 2023.
8. Preqin, as of Sept. 25, 2023.
9. Goldman Sachs Asset Management, Oct. 20, 2022. This is not intended to be an offer or solicitation to employ a specific investment strategy. Past performance is not indicative of future results. Future results are not guaranteed.
10. Global Private Equity Report 2023, Bain & Company, Feb. 27, 2023.
11. Global Private Equity Report 2023, Bain & Company, Feb. 27, 2023.

IMPORTANT INFORMATION

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