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Review and Outlook 2025

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Foreword
Symon Drake-Brockman
Founder and Managing Partner

Following the publication of Pemberton's inaugural European Direct Lending Report in 2021, we are pleased to launch the second edition of the report which reveals insightful updates on the evolution of the market and the considerable continued growth of the private credit and direct lending market.

Private credit has continued its strong growth trajectory, further establishing itself as an important asset class in investment portfolio construction. Compared to traditional capital markets, the relatively nascent sector has demonstrated strong resilience, navigating multiple market shocks – including the pandemic, the energy crisis triggered by the Russia-Ukraine conflict, record-high interest rates aimed at curbing hyperinflation, and an era of heightened geopolitical tensions.

New dynamics are shaping the industry, with increasing consolidation and heightened competition in the upper mid and large cap market. In this evolving landscape, manager expertise, discipline, and a well-defined approach are more critical than ever in delivering long-term, sustainable value to LPs.

Looking ahead, we continue to see compelling growth opportunities in the core European mid-market, where successful privately-owned businesses are being brought together to embark on expansion journeys to become Europe's future champions.

Despite the significant inflows of assets under management into European direct lending, there remains a notable lack of comprehensive academic research analysing this rapidly evolving sector in depth. To help address this, Pemberton has once again partnered with Oxford Saïd Business School to conduct an updated market review, building upon the insights from our 2021 report. Our second edition has once again also benefited by valuable contributions from Latham & Watkins, with support from NautaDutilh and Schjødt, as well as new contributions from AXA and Lincoln International.

On behalf of everyone at Pemberton, we extend our sincere gratitude to all contributors for their expertise, time, and dedication. We hope our clients and readers find this analysis insightful.

Executive Summary

Introduction

Private debt, an alternative to traditional bank and syndicated loans, has experienced remarkable growth over the past two decades. The market has increased from US$40 billion in 2000 to US$1.6 trillion in June 2024 and is projected to reach US$2.6 trillion by 2029[1], underlining private debt's growing importance as a financing alternative.

It is against this backdrop that Oxford Saïd Business School and Pemberton Asset Management have again partnered to provide an update to the 2021 report, *European Direct Lending Review and Outlook*. With key contributions from Latham & Watkins, a leading global law firm, with the assistance of NautaDutilh and Schjødt, Lincoln International, and AXA, the report aims to provide readers with insight into European direct lending: its growth, market dynamics, performance, risks and sustainable investing practices.

Private Debt and Direct Lending

Among the segments of private debt, direct lending has emerged as the largest, making up 50% of private debt assets under management (AUM) in 2024.[2] Investor sentiment toward private debt remains highly positive, driven by the current high-interest-rate environment compared to the previous decade. Surveys reveal that 37% of limited partners (LPs) plan to increase their allocations to private debt,[3] attracted by its strong yield potential. Across almost all investor categories, there is a clear intention to maintain or grow private debt allocations, underscoring the asset class's enduring appeal.

Market Dynamics

Direct lending has played a critical role in the credit market, particularly since the 2008 financial crisis when tighter banking regulations created a gap in financing for small to medium enterprises (SMEs). More recently, broader macroeconomic uncertainty has led to tighter conditions in the syndicated loan market. Direct lending has demonstrated low beta and portfolio diversification benefits, contributing to its popularity among institutional investors. Fundraising for direct lending has surged since 2020, reflecting investor interest. Meanwhile, deal flow remains robust, and "dry powder" levels have decreased as a percentage of AUM. However, concerns are rising about whether the growing pool of capital can sustain deal quality amid increased competition.

The European direct lending market experienced a significant shift in 2024, driven by a tougher M&A environment and changing financing needs. In contrast to the boom years of 2021 and 2022 – when post-COVID-19 dealmaking surged, fueling a wave of leveraged buyouts (LBOs) – current market conditions are characterised by a slowdown in M&A activity. This has led to a notable shift in the use of proceeds, with private equity-backed deal flow increasingly focusing on refinancing and recapitalisations rather than funding new buyouts.

Performance and Risks

Direct lending typically offers lower risk and return profiles compared to distressed debt. For example, direct lending vintages from 2011 to 2020 delivered a median net internal rate of return (IRR) of 8.2% compared to distressed debt's median IRR of 6.2%.[4] While the asset class has shown resilience over time, the current high-interest-rate environment raises concerns about borrower solvency. However, historical data suggests that direct lending has lower losses than comparable leveraged loans during periods of financial stress, anecdotally in part due to proactive management by lenders. This approach is said to have contributed to higher recovery rates and lower default levels, reinforcing the appeal of direct lending in volatile economic conditions.

Sustainable Investing in Private Credit

Sustainable Investing, also referred to as ESG Investing, in private debt is gaining traction, with the integration of environmental, social and governance factors (ESG) becoming more systematic and recognised as a potential source of both investment risk and value creation. Despite challenges, such as inconsistent data quality and reporting practices by private mid-market companies, industry observers note that ESG integration is advancing, driven by investor demand, regulatory developments and innovation in sustainable investing solutions.

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1 Forecast according to Preqin, Future of Alternatives 2029 Report, September 2024 https://www.preqin.com/insights/research/reports/future-of-alternatives-2029

2 Preqin Ltd, Assets Under Management for Venture Debt, Private Debt FoF, Mezzanine, Special Situations, Distressed Debt, and Direct Lending, as of Q1 2025.

3 Coller Capital's 41st Global Private Equity Barometer, December 2024

4 Preqin, Ltd, Proprietary Private Debt – Fund Database, as of Q4 2024.

Outlook and Future of Direct Lending

The future of direct lending appears robust, underpinned by institutional demand and the strategy's role in providing flexible financing for businesses. While a moderate decline in interest rates may reduce yields, direct lenders' ability to manage risk, maintain high recovery rates and offer flexible capital solutions suggests resilience. The outlook remains positive, with direct lending likely to remain a core component of private debt strategies, adapting to economic shifts and continuing to attract investor capital.

LATHAM & WATKINS

A Legal Perspective

Convergence with Syndicated Loans

There is a growing alignment between private credit and syndicated loan markets, with private credit adopting similar covenant structures, pricing, and terms. This trend is driven by competition, the increasing pressure to deploy capital, the development of stronger relationships between private credit funds and private equity sponsors, and the need for flexible financing options, benefiting borrowers with more versatile solutions.

Liability Management Transactions

These transactions (which tend to be effected in the large cap end of the market) are increasingly used by financially distressed companies to access liquidity and restructure debt, predominantly in the United States but to some extent in Europe. They involve strategies such as 'uptiering' and 'drop-downs' to realign capital structures, often executed with the support of select creditors, but can lead to conflicts with non-participating creditors.

Changed European Restructuring Landscape

The introduction by key EU member states of new pre-insolvency restructuring regimes, which in many cases permit cross-class cram down of dissenting creditor and shareholder classes, has swung the pendulum towards value preservation through offering means to address financial difficulties at an earlier stage. These tools, coupled with the English scheme of arrangement and the enhanced English restructuring plan, present debtors and creditors with a wider choice of restructuring remedies.

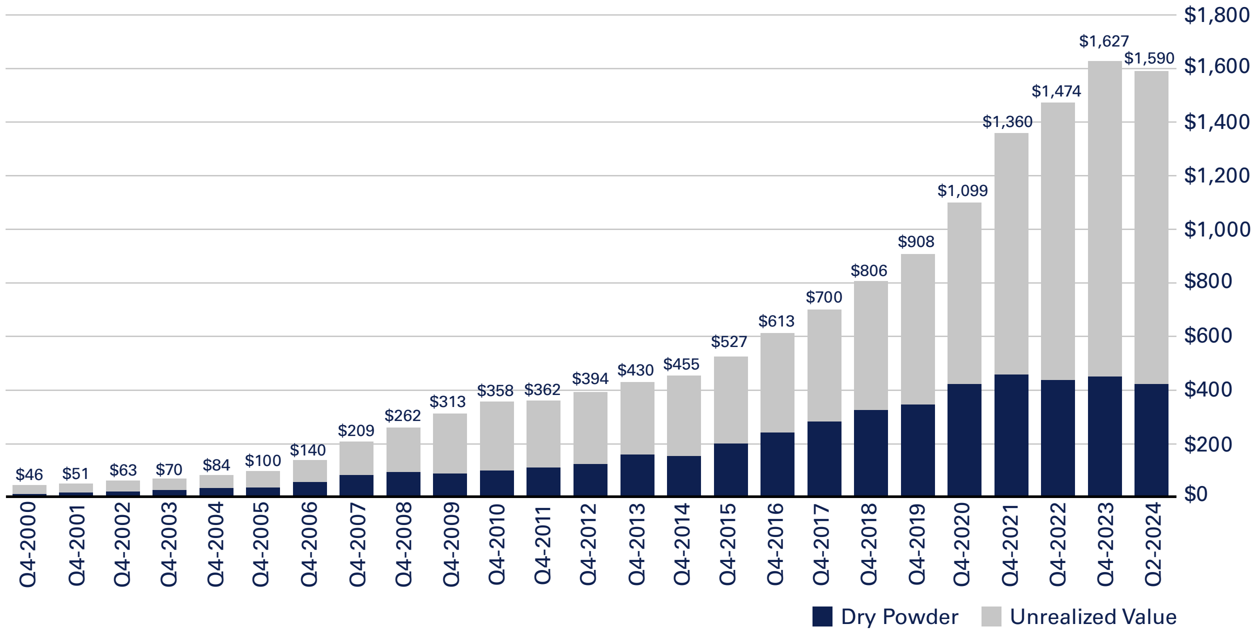
For full definitions of terms, please refer to the Glossary on page 48.

PART 1
Private Debt and Direct Lending – What Do We Know?

Private Debt and Direct Lending

Since 2000, private debt AUM has grown more than 40-fold from US$40bn to US$1.6tn in June 2024 (Figure 1). In the past 10 years alone, the asset class quadrupled in size. Private debt's growth rate picked up following the Global Financial Crisis of 2008-09, which saw a significant re-regulation of the global banking sector accompanied by waves of consolidation. It was during the post-2008 period that non-bank lenders such as Business Development Companies (BDCs) in the U.S. and private debt funds started to flourish.

Figure 1: Global private debt AUM (USD $bn)



Source: Preqin Ltd, Assets Under Management, Private Debt including Direct Lending, Mezzanine, Special Situations, Distressed Debt, FoF and Venture Debt, as of Q1 2025.

More recently, this trend has gained momentum. Since the first edition of the European Direct Lending Review and Outlook published in 2021, private debt AUM has continued to grow, reaching US$1.6 trillion by June 2024, up from US$1.4 trillion in December 2021.

The growth of private debt is thought to have filled the lending gap left by the reduced risk appetite of Europe's banking sector, in particular loans to SMEs in a space known as the middle-market. This theory gains support from recent work by Erel and Inozemtsev (2022), which links tighter bank regulation to growth in non-bank lending. Given the relatively recent emergence of private debt as an asset class, the academic literature to date is limited but is developing fast.

Defining Private Debt

Private debt broadly refers to the provision of debt finance to companies from funds, rather than banks, bank-led syndicates, or public markets. Unlike public debt, which is traded on financial markets, private debt is typically negotiated directly between the borrower and lender and is not publicly traded. The distinction between private and public debt is akin to the distinction between private equity and public (or listed) equity, with some nuanced differences.

Private debt can be broken down into several sub-categories including distressed debt, real estate debt, mezzanine, venture debt and direct lending, the focus of this report. Table 1 illustrates the position of private debt in relation to other major asset classes. We have not considered derivative instruments (e.g. CDS) in the analysis.

Table 1: Summary of the primary recognised sub-categories within debt and equity and the place of private debt (and direct lending) among them

	Public	Private
Equity	Stocks ETFs REITs	Private equity Privately owned companies
Interest rates / Government Debt	Government bonds – supranational bonds, agency bonds, treasury bills	SSA (Sovereigns, Supranationals and Agencies) private placements, commercial paper
Credit	Corporate Bonds – Investment Grade and High-Yield Broadly syndicated loans	**Bank Loans:** Bi-lateral or club-based lending, very limited secondary market liquidity. **Private Debt:** Direct lending and real estate, mezzanine / junior finance, hybrid capital instruments, mid-market CLOs, asset-backed lending, infrastructure debt, consumer / marketplace lending, royalties, venture debt, rescue financing, reinsurance and litigation finance.

Source: Pemberton

Defining Direct Lending

Direct lending traditionally comprises secured loans made to sub investment-grade borrowers. However, it is becoming increasingly common for direct lenders to provide financing solutions that span the capital structure, from traditional senior secured loans to junior debt and hybrid instruments. 'Secured' in this context means secured by cashflows, i.e. via a share pledge, and should not be confused with loans collateralised by property, plant and equipment or other 'hard' assets. While direct lending loans may also have security over hard assets, it is the cashflow-generating ability of the borrower and the ability to sell the company as a going concern that provides the principal source of recovery in a default situation. A typical direct lending debt quantum in Europe is in the €25m – €300m range with margins between 4.5% and 8% above risk free rates.[5] There are, of course, exceptions to these ranges.

The academic research discussed below shows that many banks have withdrawn from certain lending markets. It is worth noting that banks are often an important part of the capital structure in direct lending transactions. They provide amortising term loans, super-senior revolving credit facilities (RCFs), and working capital facilities. In some cases, they may also co-invest in the same tranche, especially when material ancillary revenues are available to the banks (FX hedging, cash management, interest rate derivatives, etc.). The middle market, or mid-market for short, is broadly understood and referred to as lending to companies with enterprise values in the range of €50m–€500m or EBITDA from €10m–€50m.

Table 2 below summarises the typical attributes of a direct lending fund.

Table 2: Direct lending fund structure and terms

Structure: Direct lending funds are structurally similar to private equity funds, adopting a Limited Partner / General Partner (LP / GP) setup.

Management Fee: On average, direct lending funds take lower risk and target lower returns than private equity; management fees are typically calculated as a percentage of invested capital and range between 0.5–1.5%, although some funds may still charge on committed capital. In earlier rounds of fundraising or if asset managers are not as established in the marketplace, they typically offer discounts for early investors in the fund.

Performance Fee: The performance fees of direct lending funds are typically calculated as a percentage of profit, subject to a hurdle rate and (usually) catch-up. The hurdle reflects the return at which the manager starts to generate performance fees, while catch up is a period of outsized allocation to the manager, above the hurdle rate, until the manager has received their carry percentage on all returns above 0%, not just the hurdle. Typical performance fees are around 10% although the performance fees, hurdle rate, and catch up may vary from fund to fund.

Investment Period: Direct lending funds typically have a four to five-year investment period, with recycling. The typical investment period is the duration from a fixed date, typically the first or final fund close date, where the GP can draw funds to invest. The recycling provision gives funds the ability to reinvest capital from early sales or realisations, providing for higher average deployment of LP capital through the fund life.

Fund Life: The fund life is the total duration of the fund. There is usually an extension provision to cater for cases where it is suboptimal to liquidate certain investments and major LPs may have to approve the extension. Typical direct lending funds have legal tenors of seven to eight years.

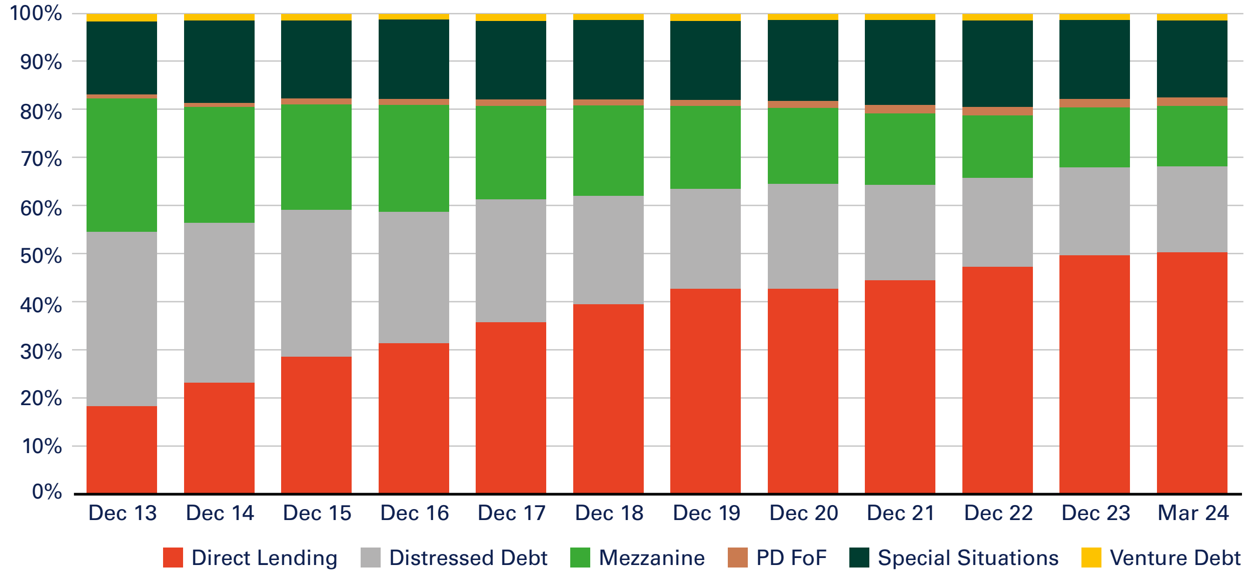
Source: Pemberton, Oxford's conversations with private market professionals.

[5] Pemberton's understanding from discussions with industry practitioners.

Direct Lending's Dominance Grows

Traditionally, direct lending[6] has been the dominant strategy of private debt funds, making up 50% of the market by AUM in 2023 and 2024 (Figure 2). In an early study of the performance of private debt funds, Munday, Hu, True and Zhang (2018) find that they demonstrate low beta and positive alpha compared to leveraged loans or high yield debt. This result is supported by Loumioti (2019), who shows that direct loans exhibit similar or somewhat better performance than bank-originated loans. From a portfolio management perspective, Munday et al. (2018) also argue that that direct lending's low correlation with leveraged loan and high-yield indices may indicate that the strategy offers diversification benefits.

Figure 2: Percentage of global private debt AUM by strategy and vintage



Source: Preqin Ltd, Assets Under Management for Venture Debt, Private Debt FoF, Mezzanine, Special Situations, Distressed Debt, and Direct Lending, as of Q1 2025.

Further work on direct lending has highlighted its strengths. Loumioti (2019) presents evidence that direct lending has expanded the addressable market for credit without giving rise to adverse selection costs. This suggests that direct lending operates both as a substitute for bank lending and as a complement to it, to some degree at least. Davydiuk et al. (2020), studying BDCs, find that direct lending has stimulated economic growth and innovation. These strengths of direct lending contrast with arguments advanced by Chernenko et al. (2022) that unprofitable and highly indebted companies are more likely to borrow from direct lenders.

Given that direct lending is said to operate in part as a substitute for bank lending (Loumioti, 2019, Davydiuk et al., 2020, Chernenko et al., 2022), some studies have attempted to compare and contrast lending by banks and direct lenders. Loumioti (2019) studies these differences in loans to non-private-equity-sponsored companies while recent work by Jang (2023) examines loans made to sponsor-led firms. These studies show that direct loans have more flexible covenants than bank loans but charge higher interest rates and are more likely to be secured against the borrower's capital, via a share pledge that gives the lender a call on its cash flows.

The flexibility of direct lenders in underwriting their loans also extends to restructurings in distressed situations. Jang (2023) finds that during the COVID-19 pandemic, direct lenders were more flexible than banks in resolving distress through negotiations (rather than going to court). In addition, Jang (2023) argues that direct lenders' relationships with sponsors were associated with continued lending during the pandemic, thus offering stability of funding in a time of economic uncertainty.

[6] In direct lending, the loan is bilaterally negotiated between a borrower and a single lender (or a small group of lenders) with the expectation that the lender holds the loan to maturity (Block et al., 2023). This contrasts with most bank-originated loans that are syndicated to and subsequently traded in the secondary market among institutional investors (Block et al., 2023).

Direct Lending vs. Syndicated Bank Lending

Based on interviews with industry professionals, Table 3 below summarises the perceived competitive advantages and disadvantages of private debt, syndicated market and bank lending from the perspective of a potential borrower.

Table 3: Pros and cons of direct lending, syndicated market and bank lending

	Direct Lending	Syndicated Market	Bank Lending
Loan size	~€25m to ~€1bn+	~€250m+ syndicated market	~€1m to €250m (varies by region)
Privacy	Information remains private (typically single lender)	Information remains private among a broader range of investors (including trading desks)	Information remains private (ranging from 1–5 banks typically)
Process speed	Quick underwriting process	Slower underwriting and issuance	Slower underwriting process
Deal-specific flexibility	Most bespoke solution More flexible than bank lending, less than Syndicated market	Flexible	Most rigid
Pricing	Most expensive	Less expensive. Deal specific pricing depends on rating (no market for unrated issuance)	Least expensive
Pricing risk	Once agreed with lender, is typically fixed	Risk of upward re-pricing during syndication process, although could also re-price downwards	Once agreed with lender, remains fixed
Flex	Once agreed with lender, terms are fixed (i.e. no flex)	Risk of structural and documentation concessions (although becoming less common as a flex item)	Once agreed with lender, terms are fixed (i.e. no flex)
Amortisation	Usually none	Usually none for syndicated loans	Often included, particularly for smaller and riskier businesses
Other costs	Limited due to lower legal fees and no loan rating required	Loan rating fees to rating agencies apply	Limited due to low legal fees and no loan rating required
Prepayment penalty	More expensive – often charge prepayment penalties during a minimum of 24 months post issuance	Least expensive – often soft prepayment premium for 6 months	Range of options between direct lending standard and no prepayment fees

Source: Interviews with industry professionals and Pemberton.

The actual pros and cons for each borrower will reflect the borrower's individual circumstances and depend on market conditions at the time the loan is made.

Risks in Direct Lending

Interest Rate Risk

It is important to distinguish the risks of rate hikes on direct lending along several dimensions: a) risk to the appeal of direct lending to investors, b) default risk of borrowers and c) returns (interest rate duration).

a. Risk to the appeal of direct lending to investors

The influx of capital to direct lending pre-2022 was partly attributed to industry participants' search for yield during the low interest rate environment.

One worry was that rising interest rates might have reduced institutional investors' asset allocations to private debt as traditional forms of debt such as bonds and higher credit quality assets (i.e. Investment Grade) were once again able to meet investors' return requirements. It was therefore conceivable that an increase in interest rates might have made private debt less attractive compared to other debt securities.

However, despite inflationary pressures in 2022 and the subsequent return of positive base rates across the major direct lending currencies,[7] AUM has continued to grow and previous concerns have subsided. Private debt AUM is expected to increase from US$1.5 trillion in 2023 to US$2.6 trillion by 2029.[8]

However, rising rates reduced the value of existing High-Yield bond portfolios (or any asset with fixed coupons) as legacy coupons struck in a low-rate environment were discounted at higher prevailing rates. This gave rise to the so called "denominator effect", whereby allocators became temporarily overweight on alternatives, purely by virtue of the portfolio value of liquid fixed rate holdings decreasing. Therefore, whilst there was a temporary impact on direct lending allocations, this effect has now largely run its course as interest rate cuts have flowed through. In addition, returns from direct lending remained attractive thanks to its floating rate coupons, which highlighted the stable nature of returns and relative value in direct lending as compared to fixed income alternatives – a boon for fundraising.

Unlike public market funds, direct lenders can benefit from locked up capital, meaning no outflows or forced liquidations. In fact, many were thus able to capitalise on fire sale prices available for a matter of weeks in March and April 2022 and hung syndications when public markets shut in summer 2022, as was the case during COVID-19 and other macro shocks.

b. Default risk due to rising rates

According to industry professionals, direct lending, like the syndicated loan and commercial banking markets, is mostly contracted on a floating rate basis. This is also observed in Pemberton's data. As a result, in a rising rate environment, borrowers face increasing debt service costs. In some cases, higher interest obligations may trigger a higher rate of defaults. At an aggregate level in the U.S., direct lending default rates rose from 2.5% in 4Q21 to 4.5% in 1Q23 but have since returned to historical lows of 2.2% as of 3Q24.[9] The extent to which funds require borrowers to hedge interest rate risk may vary, but data suggests borrowers have largely mitigated the impact of higher rates on debt service requirements.

Given that rates tend to increase in improving macroeconomic environments, the underlying business risk may decline at the same time, perhaps more than offsetting the detrimental effect of rising rates on borrower default risk. Either way, LPs interested in limiting their interest rate risk are well-advised to ascertain information on interest rate hedging from GPs.

c. Return impact

Looking back over the last four years since the COVID-19 pandemic, the direct lending market has consistently delivered a 200–300bps premium above the syndicated market, as observed in Pemberton's data. Despite several economic shocks – such as the Ukraine crisis, high inflation, and a challenging environment for many businesses – direct lending has maintained low default rates. The floating rate nature of loans, typically with maximum annual interest periods, means the interest rate sensitivity of their prices is very limited. Rising rates increase the returns from existing assets.

Foreign Exchange Risk

Direct lending funds are exposed to currency risks to some degree but implement measures to manage it. If underlying loans made by direct lenders are arranged in the fund's local currency, and the borrower's cashflows and business are exposed only to that local currency, then the fund has no FX exposure. In cases where the loan and the fund use different currencies, the principal balance of the loans is typically hedged via vanilla FX forwards on a rolling basis. In cases where a loan is made in the fund's local currency, but the borrower's business is international (i.e. it relies on cashflows in a non-local currency), direct lenders typically specify hedging requirements to ensure debt serviceability is not compromised by FX fluctuations. As such, direct lending has put in place numerous measures to manage foreign exchange risk. Again, variation may exist across funds in their policies.

7 EUR, USD, GBP.
8 Preqin Ltd, Future of Alternatives 2029 Report, September 2024 https://www.preqin.com/insights/research/reports/future-of-alternatives-2029
9 Q3 2024 Lincoln Senior Debt Index- Lincoln International LLC see default rates chart

Regulatory Risk

This analysis is presented against a backdrop with little to no increase in private debt regulation currently being publicly contemplated. Nonetheless, growth in direct lending and private debt more broadly might be threatened by regulatory changes. The press has frequently expressed concerns that private debt funds contribute to the growth of the shadow banking sector and might increase systemic risk.[10] So have former Fed officials and prominent private equity scholars, who warn of the opacity of the sector, the vulnerability of loan portfolios to a credit crunch in a downturn, and the risk of runs on open-ended funds (although not direct lending, which is closed-ended). However, scholars also acknowledge that for the time being the sector shows no sign of slowing down and that a credit crunch in the banking sector might also lead to increased demand for private debt.[11] Nevertheless, debt provided by private debt funds can increase total debt in the system, with negative externalities for other participants.

As mentioned above, direct lending funds are typically closed-ended, and so they are not exposed to the structural liquidity mismatches that have traditionally caused problems in the banking system. The empirical question of whether debt provided by private debt funds in fact increases systemic risk is beyond the scope of this report. A perception among regulators that private debt leads to increased systemic risk might lead policymakers to regulate the sector, which could negatively affect its growth rate and/or ability to generate returns. Recall that increases in direct lending AUM represent a small fraction of the 90% of GDP that has been run off from European banks' balance sheets. Historically, comments from regulators (including ex-Fed chair Janet Yellen) have instead focused on underwriting standards in syndicated loan markets.

Additionally, there could also be an indirect effect on the growth of direct lending through the regulation of private equity. While non-sponsored direct lending continues to expand, private equity-sponsored deals have historically driven a significant share of its growth. If new policies restricting private equity buyout activity gain traction, they could indirectly slow the growth of direct lending tied to sponsored deals while further accelerating the shift toward non-sponsored lending.

Default Risk and Covenants in Direct Lending

Covenants in direct lending are essential tools that provide lenders with oversight and protection by imposing financial discipline on borrowers. They are generally divided into incurrence-based covenants, which are activated when a borrower undertakes specific actions such as issuing dividends or incurring additional debt, and maintenance covenants, which require borrowers to stay within certain financial limits, such as a maximum net debt-to-EBITDA ratio. These maintenance covenants are typically tested every quarter. Covenants grant lenders a degree of control and serve as early warning mechanisms to mitigate potential risks.

Since the Global Financial Crisis, there has been a notable decline in the use of maintenance covenants across both syndicated loans and direct lending. Table 4 illustrates this decrease in the use of covenants in the context of senior loans by comparing the use of covenants by banks and direct lenders.

Table 4: Use of covenants across bank lending and direct lending over time

	Post-crisis period	Today
Commercial Banks	3–4 Covenants	1–2 Covenants
Syndicated Markets	1–2 Covenants	90% Cov-lite (i.e. no covenants)
Direct Lending	4+ Covenants	1 Covenant, typically net leverage covenant (becoming increasingly common to see no financial covenant on top tier sponsored deals)

Source: Interviews interviews with industry professionals and Pemberton's understanding of the market. No banks were interviewed.

10 See, e.g. https://www.ft.com/content/2965ff84-6ed2-11e6-a0c9-1365ce54b926
https://www.ft.com/content/4610e820-1b09-11e9-9e64-d150b3105d21

11 https://www.marketwatch.com/story/shadow-banking-is-growing-remains-opaque-and-carries-uncertain-risks-for-the-economy-2020-01-04

According to PitchBook Leveraged Commentary & Data (LCD), more than 90% of syndicated loans are covenant-lite, i.e. containing no maintenance covenants.[12] Direct lending, while traditionally more conservative, has also seen a shift toward looser covenant structures, especially in larger transactions. S&P Global explored this in a recent analysis which reviewed more than 1,000 credit agreements from loans executed in 2023 and found that maintenance covenants were less common among larger deals.[13] To remain competitive, private credit funds in the U.S., and in some cases in Europe, have adopted "covenant loose" terms for large cap-deals, reducing the stringency of their covenant packages. These loans typically include at least one financial maintenance covenant, such as a quarterly tested leverage ratio, with cushions that are set at levels making it unlikely they will be triggered.[14]

Table 5 Pemberton's view of relative strengths of documentation, presented from a lenders perspective

Document Point	Syndication Loans	Direct Lending	High-Yield
Pricing	Ranking 2	Ranking 1	Ranking 2
Documentation	Ranking 2	Ranking 1	Ranking 3
Security package	Ranking 2	Ranking 1	Ranking 3
Debt Incurrence	Ranking 2	Ranking 1	Ranking 3
Restricted payments	Ranking 2	Ranking 1	Ranking 3
Acquisitions	Ranking 2	Ranking 1	Ranking 3
Baskets	Ranking 3	Ranking 1	Ranking 2
Mandatory prepayment	Ranking 2	Ranking 1	Ranking 3
Call protection	Ranking 3	Ranking 2	Ranking 1
Financial covenants	Ranking 2	Ranking 1	Ranking 3
Synergies	Ranking 2	Ranking 1	Ranking 3
Reporting	Ranking 2	Ranking 1	Ranking 2
Amendments	Ranking 2	Ranking 1	Ranking 2
Overall	**Ranking 2**	**Ranking 1**	**Ranking 3**

This is based on Pemberton's current market observations and responsible assumptions, at the time of writing. The conclusions reached are believed to be reasonable by us at the time.

12 https://pitchbook.com/leveraged-commentary-data/leveraged-loan-primer#private-credit
13 https://www.spglobal.com/ratings/en/research/pdf-articles/241204-global-credit-outlook-2025-promise-and-peril-101609737
14 https://www.troutman.com/insights/recent-trends-in-private-credit.html

PART 2
Market Dynamics

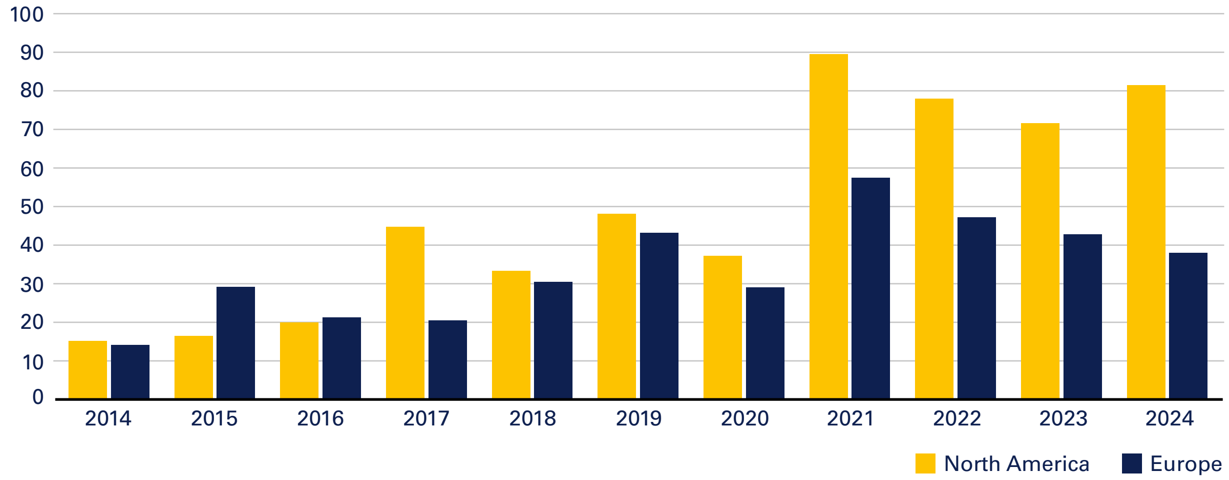
Summary

This section discusses market dynamics including trends in fundraising, the balance of sponsored and non-sponsored deals and the use of funds.

Fundraising Growth

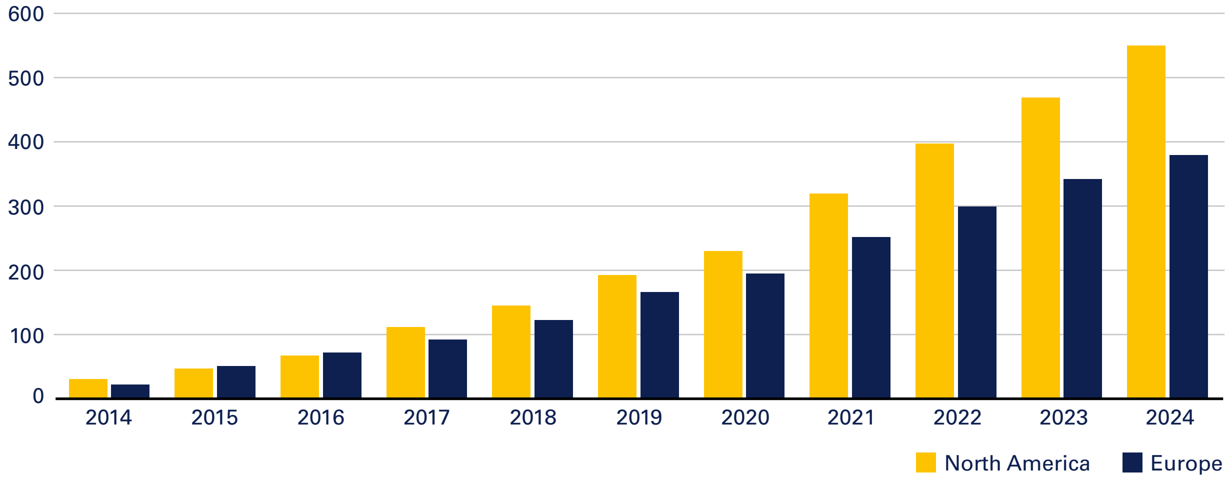
Direct lending fundraising has been especially buoyant since 2020 but experienced dips in both 2022 and 2023 (Figure 3), when interest rates began to rise to combat accelerating inflation. In North America, fundraising volumes in 2024 exceeded those of 2022. In Europe, the average funds raised over the past four years (2021 to 2024) are 73% higher than the average before COVID-19. The trend of increased fundraising, particularly in North America, has fed through to record AUM of US$550bn in the North American market and US$380bn in Europe as of June 2024 (Figure 4).

Figure 3: Ten-year direct lending funds raised (USD $bn), North America vs. Europe



Source: Preqin Ltd, Historical Fundraising, Direct Lending in North America and Europe, as of Q1 2025.

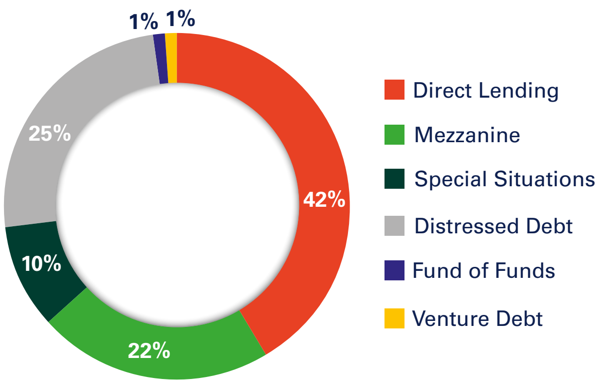
Figure 4: Ten-year direct lending AUM (USD $bn), North America vs. Europe



Source: Preqin Ltd, Historical Fundraising (cumulative), Direct Lending in North America and Europe, as of Q1 2025.

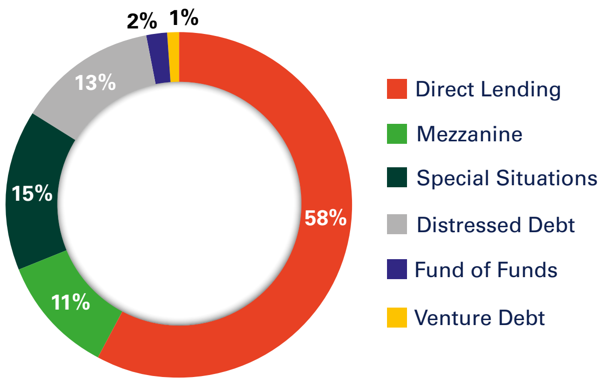
This uptick in fundraising has resulted in direct lending strategies increasing their dominance of the private debt asset class, achieving much faster growth than other private debt strategies. The result is that since 2020, direct lending's share of total capital raised for private debt strategies has risen from 42% for the period 2014–2018 (Figure 5A) to 55.7% for funds raised between 2019–2024 (Figure 5B).

Figure 5A: Proportion of aggregate capital raised by private debt funds by fund type, 2014–2018 (Total US$516bn)



Source: Preqin Ltd, Historical Fundraising, Direct Lending, Mezzanine, Special Situations, Distressed Debt, Private Debt FoF, Venture Debt, as of Q1 2021.

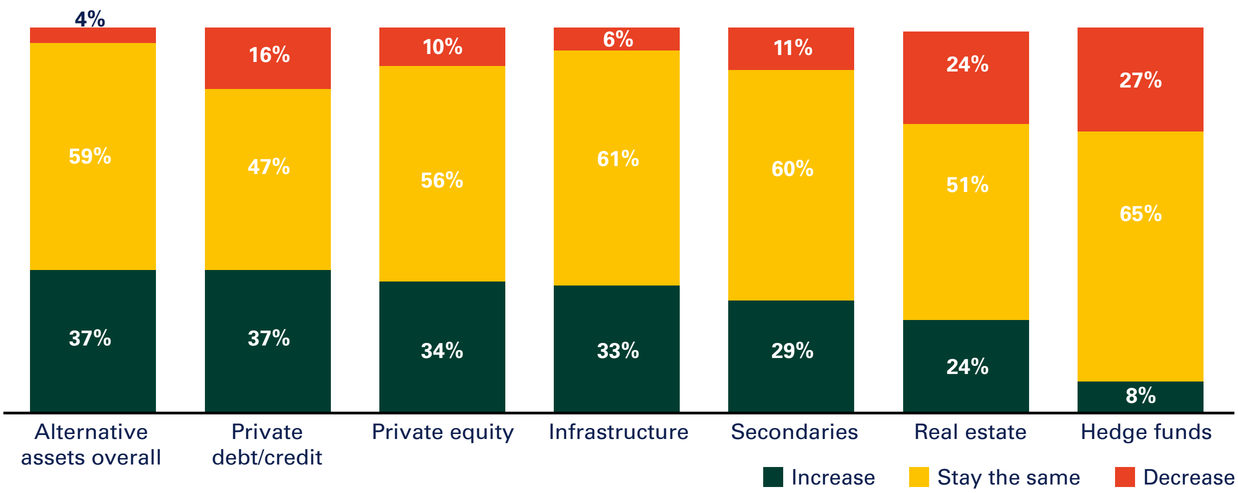
Figure 5B: Proportion of aggregate capital raised by private debt funds by fund type, 2019–2024 (Total US$1.22tn)



Source: Preqin Ltd, Historical Fundraising, Direct Lending, Mezzanine, Special Situations, Distressed Debt, Private Debt FoF, Venture Debt, as of Q1 2025.

There is evidence from investor surveys that AUM growth in private debt strategies will remain strong. For example, Coller Capital's 41st Global Private Equity Barometer reports that 37% of the LPs that took part in the survey expected to increase their allocation to private debt, reflecting the enthusiasm for the asset class. (Figure 6).

Figure 6: In the next 12 months, how do you expect your target allocation to alternative assets to change?



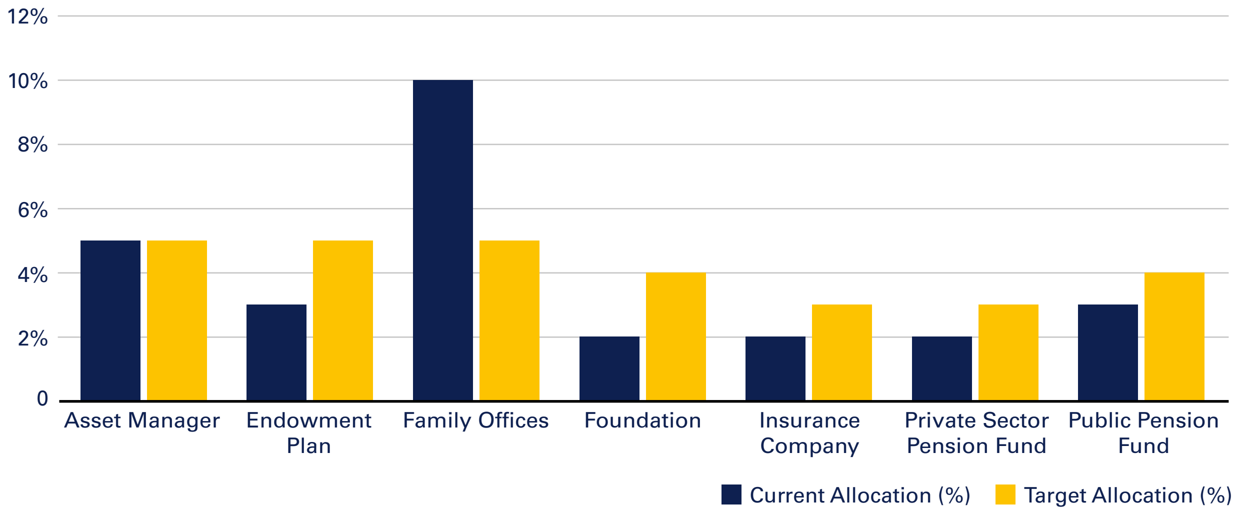
Source: Coller Capital's 41st Global Private Equity Barometer, December 2024.[15]

Data from Preqin (Figure 7) shows that almost all investor types expect to maintain or increase their exposure to private debt to reach their target allocations. The only exception is family offices, which on average have a significantly higher current allocation to private debt than any other class of investor.

Despite this growth, private debt remains a small component of portfolio allocation, typically representing 5% or less of portfolios. Growth in target allocations could reasonably be expected as private debt's market share is compared to non-investment grade and investment grade securities.

[15] https://www.collercapital.com/41-barometer-winter-2024/

Figure 7: Investors' median current and target allocations (% of total AUM) to private debt 2023



Source: Preqin Ltd, Private Debt Median Investor Allocations, by Investor Type, Global, as of December 2023.

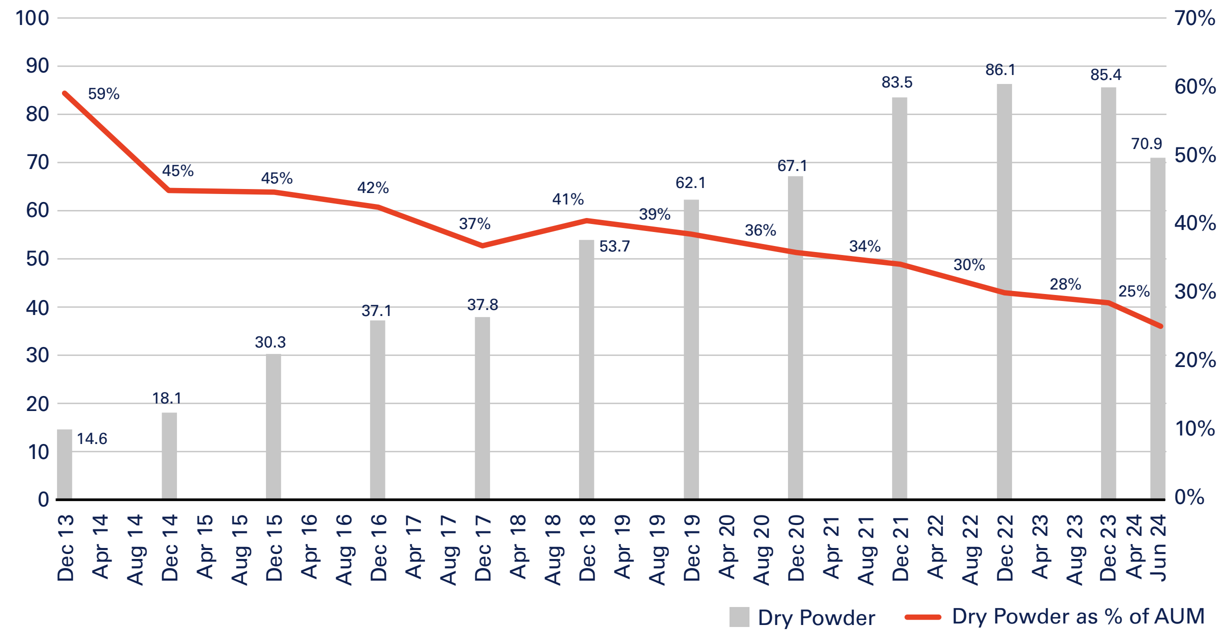
Record levels of AUM in direct landing strategies raise two major concerns:

i) Given the increased supply of capital, are direct lending managers able to source and complete enough deals?

ii) If they can source sufficient deals, is deal quality maintained? Are they accepting greater risks or compromising on returns? We consider the questions of performance and risk in Part 3.

The dollar amount of dry powder (uninvested capital) available to European direct lending funds as of June 2023 had quadrupled since 2013 (from US$17bn to US$68bn). However, dry powder as a percentage of total AUM decreased sharply over the same period, falling to 25% by June 2024 (Figure 8). This suggests that direct lending managers have not faced difficulty in deploying the capital LPs have allocated to their strategies.

Figure 8: Dry powder of european direct lending funds (USD $bn) from 2013 to 2024



Source: Preqin Ltd, Assets Under Management and Dry Powder, Direct Lending Europe, as of Q1 2025.

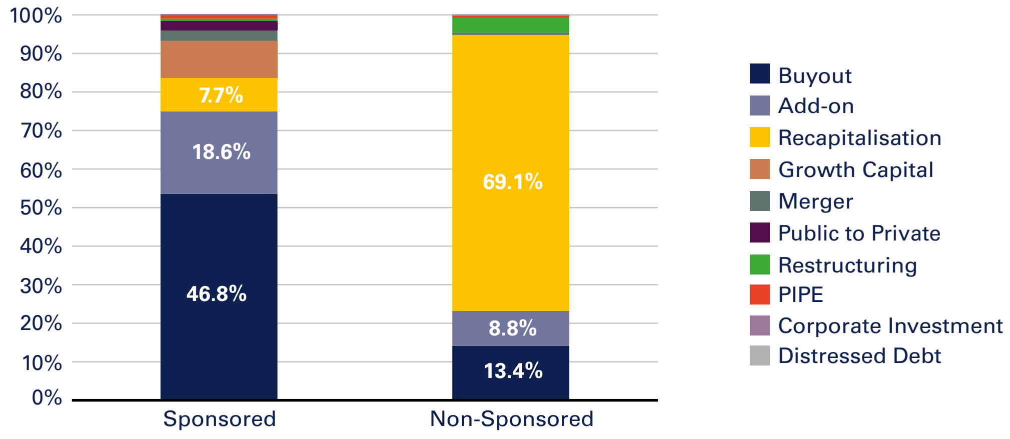
Direct Lending Use of Funds

Since interest rates started to rise, the composition of direct lending deals has also changed. Among sponsored deals, the proportion used to support buyout transactions has declined from 47% in the period from 2014 to 2021 – when the number of buyout deals peaked at almost 13,500 with an aggregate value of more than US$1.6 trillion – to 41% from 2022 to 2024, which saw a rapid rise in interest rates to address inflation (Figures 9A and 9B).

By contrast, the proportion of direct lending deals used to finance add-on acquisitions has increased almost 50%, climbing from 19% in the 2014–2021 period (Figure 9A) to 29% during the three subsequent years (Figure 9B). This shift chimes with anecdotal evidence from industry participants that, once interest rates began to rise, buyout firms shifted their focus from new acquisitions to concentrate on expanding existing portfolio companies through add-on acquisitions.

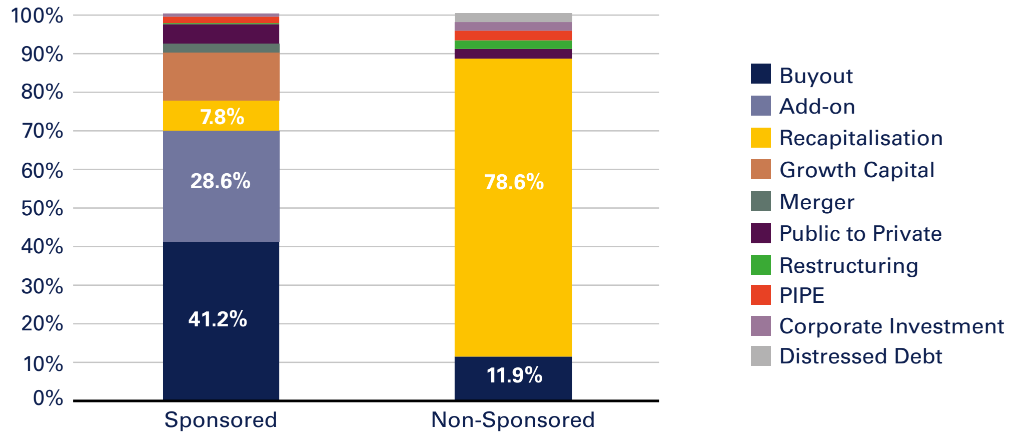
Furthermore, private equity firms are holding companies for longer durations due to hampered exit valuations, which have been impacted by higher inflation, higher interest rates, weaker economic growth, and lower consumer spending.

Figure 9A Private debt number of global deals by purpose 2014–2021



Source: Preqin Ltd, Proprietary Private Debt- Deal Database, as of Q4 2024; charted and calculated by Pemberton.

Figure 9B Private debt number of global deals by purpose 2022–2024



Source: Preqin Ltd, Proprietary Private Debt- Deal Database, as of Q4 2024; charted and calculated by Pemberton.

A marked shift in the use of funds raised through direct lending deals has also been observed among non-sponsored deals. Among these companies, the proportion of recapitalisations has increased from 69% in the previous period to 78% in 2022–2024. At the same time, the proportion of buyouts has decreased marginally from 13% to 12%, while the number of add-on acquisitions fell from 9% to zero. These changes are consistent with the expectation that as the cost of debt increases, companies concentrate on optimising their capital structure.

PART 3
Performance and Risks

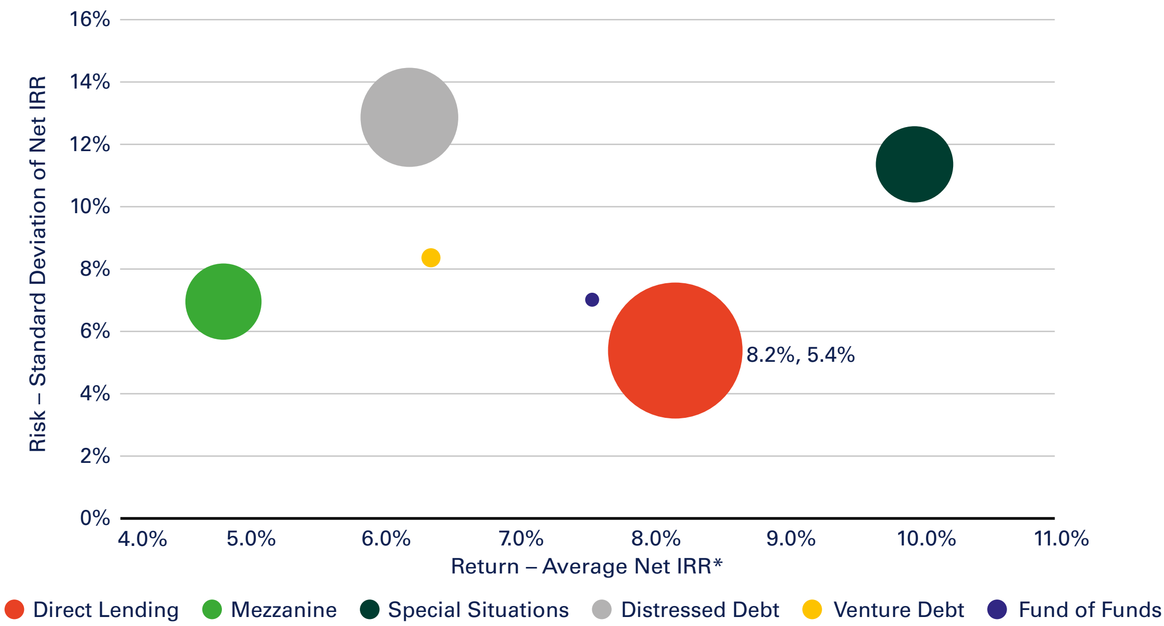
Summary

This section discusses performance and risks of direct lending compared with other sources of debt finance, notably leveraged loans and high yield bonds.

Risk-Return Profiles

The private debt asset class comprises of a range of strategies with varying relative risk-return profiles, which are presented in Figure 10 using net internal rates of return (IRR). While IRRs are commonly used as a measure of performance among industry participants, the issues associated with IRR as a measure of performance have been widely recognised and documented in academic literature.

Figure 10: Risk / return by fund strategy (2011–2020 vintages)



Source: Preqin Ltd, Proprietary Private Debt – Fund Database, as of Q4 2024; charted and calculated by Pemberton.

*IRRs are calculated or reported in the currency the fund performance source has reported in – no conversions have been made.

IRRs, especially among young funds, may be distorted due to several factors, such as the timing of cash flows, valuation methodologies, and early-stage fund dynamics. These distortions may result in artificially high or low IRRs that do not accurately reflect the true performance of the fund.

To minimise the influence of such distortions, median IRRs across funds are reported as a proxy for aggregate strategy performance. Aggregate risk for each investment strategy is assessed by calculating the standard deviation of net IRRs; however, this metric is not directly comparable to public market risk measures, such as volatility derived from daily price fluctuations.

The standard deviation of IRRs reflects the variability in performance across private funds within a strategy, driven by differences in investment horizons, portfolio composition, and fund-specific factors, making it a unique and context-specific metric.

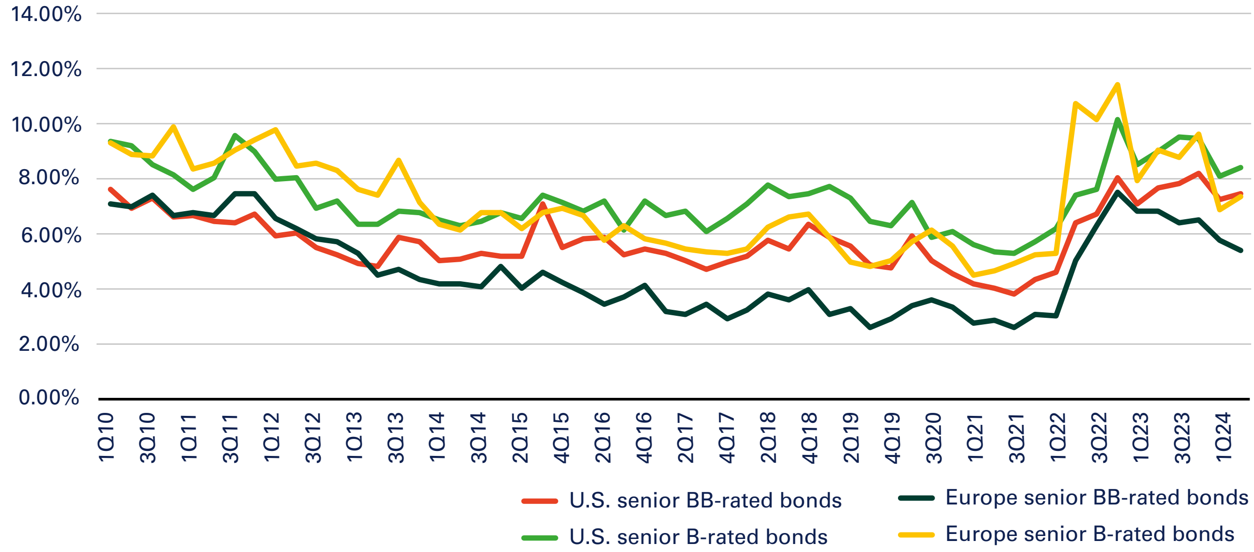
On average, direct lending funds with vintages between 2011 and 2020 had a median net IRR of 8.2%, with a standard deviation of 5.4% (Figure 10). Notably, direct lending has the lowest variability of returns which is consistent with expectations as direct lending loans are typically at the senior end of the capital structure.

Risks

Next, we turn our attention to risks. In view of the paucity of data on direct lending defaults and losses, we use information on comparable publicly traded bonds to estimate direct lending risks in the current higher interest rate environment.

As central banks increase rates, the yields of new bonds also increase as can be observed from the beginning of 2022. However, the spreads between new-issue yields of senior B and BB-rated bonds and 10-year Treasury yields have remained reasonably stable for much of the period from 2010 to Q1 2024 (Figure 11). This does not suggest that investors regarded these bonds as materially more risky in an environment where interest rates were rising, although during 2022 spreads on European senior B and BB-rated bonds widened more than their U.S. equivalents (Figure 12).

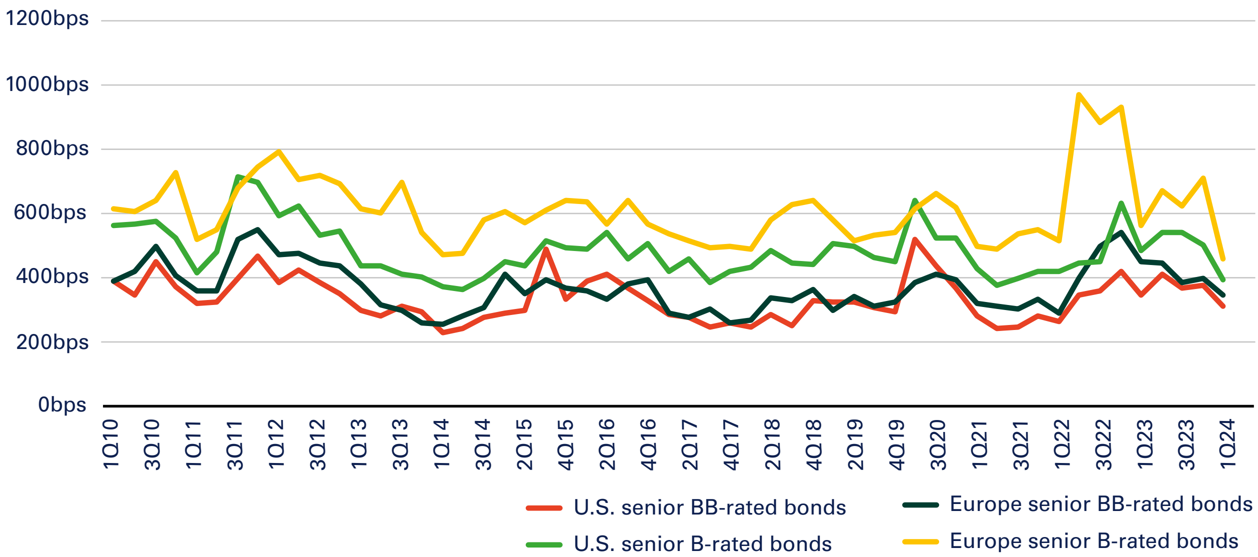
Figure 11: New issue yields* – senior BB- and senior B- U.S. and European bonds for the period 2010 to 2024



Source: LCD Pitchbook Data, Inc., Global Interactive Loan Volume Report, as of Q2 2024.

*The chart displays percentage yields and does not include specific currency amounts. LCD reports that investment growth rates are universally comparable when measured over the same time frame, even if the base currencies differ.

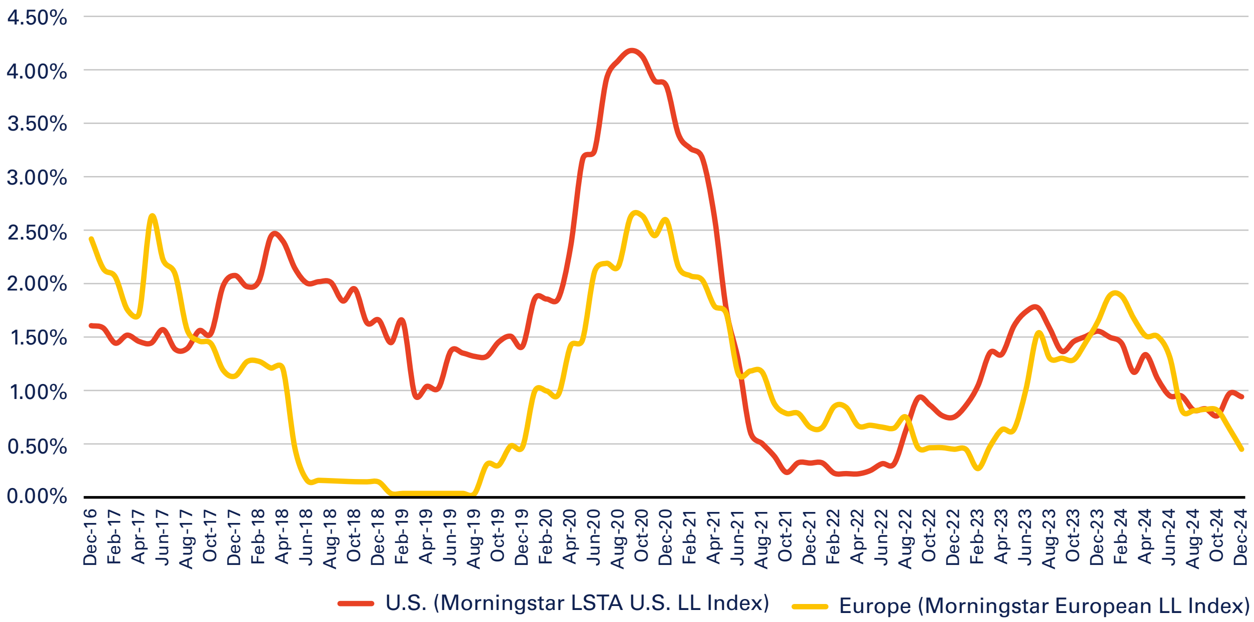
Figure 12: New issue yields – spreads vs. 10-year bonds (U.S. Treasury and German Bund) from 2010 to 2024



Source: LCD PitchBook Data, Inc., Federal Reserve Bank of St. Louis, as of Q2 2024.

A common narrative often repeated in the media is that as interest rates rise, the risk of loan defaults also increases. This assertion can be tested by referring to the performance of leveraged loans during the recent period of rate increases. According to Morningstar's leveraged loan indices for the U.S. and Europe, default rates rose through 2023 as the effects of higher rates on these floating-rate instruments fed through. However, on a variety of measures defaults remained well below previous peaks, most recently the final quarter of 2020, immediately following the pandemic shock (Figure 13).

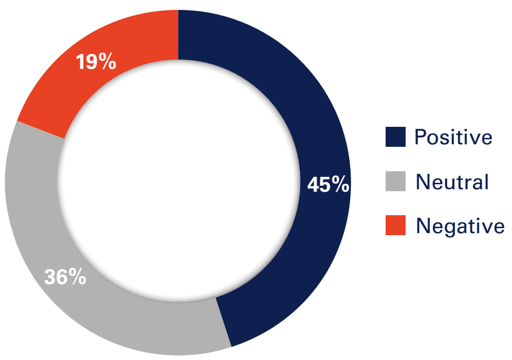
Figure 13: Euro vs. U.S. lagging 12-month loan default rate – based on principal amount



Source: LCD Pitchbook Data, Inc., as of Q1 2025.

It is also worth noting that many LPs do not appear to regard rising interest rates as a major threat to the performance of private debt portfolios. Investors surveyed for Coller Capitals' 39th Global Private Equity Barometer in December 2023 (Figure 14) were largely untroubled by the expected effects of rising rates, with more than 80% regarding them as positive for performance or neutral.

Figure 14: Impact of higher interest rates on performance of private debt portfolios



Source: Coller Capital's 39th Global Private Equity Barometer, December 2023.[16]

[16] https://www.collercapital.com/barometer-winter-2023-24/

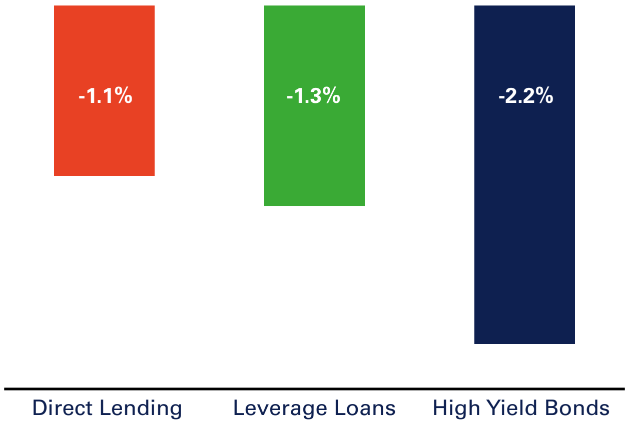
Default and Loss Rates

Please note, in the absence of reliable data from Europe, Figures 15, 16 and 17 in this section refer to U.S. market data, which we believe serves as an indicator of these asset classes' performance in Europe.

According to Morgan Stanley, in the U.S., direct lending losses during the pandemic appear lower than for comparable leveraged loans and high-yield bonds (Figure 17). These figures, however, require a caveat: it is unclear whether the lower loss rate attributed to direct lending is due to less data transparency or less frequent updating of portfolio valuations.

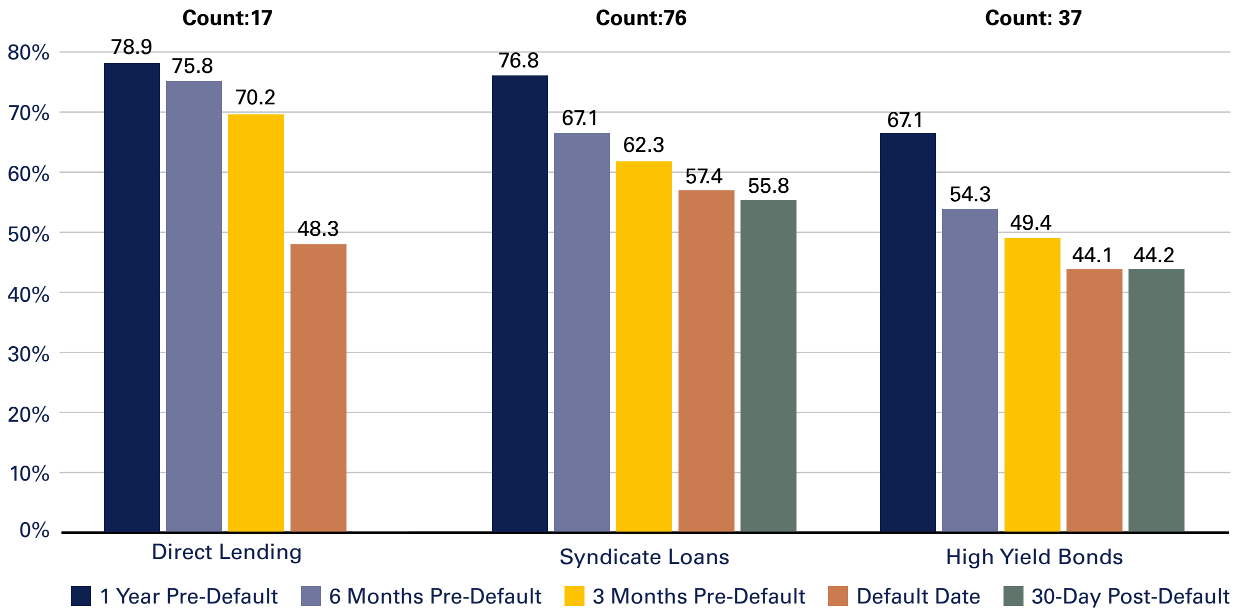
An April 2024 report from J.P. Morgan Private Bank, citing research by the Federal Reserve based on data from the rating agency KBRA, suggests that direct loans tend to be held at higher values than syndicated loans and high yield bonds one year, six months and three months pre-default (Figure 16). This supports the view that delays in writing down direct lending valuations may be creating the impression that direct lending portfolios have lower loss rates than syndicated loans or high yield bonds. While there is potential for short-term opacity, reporting on losses remains an inevitable part of the medium-term reporting cycle.

Figure 15: Direct lending's fewer losses during COVID-19 (the U.S.)[17]



Source: Morgan Stanley, June 2024[18] Note: U.S data.

Figure 16: TTM average post-default values,* unweighted (U.S.)



Source: J.P. Morgan, KBRA DLD, Solve, April 2024.[19]
*Direct lending 30-day post-default levels are taken using the default.

[17] Data represents the period from Q1'08 to Q3'23. Calculated as annualized average returns divided by volatility. Volatility is measured using standard deviation. "Direct Lending" is represented by the Cliffwater Direct Lending Index (CDLI) and is calculated from quarterly data, which has been annualized. "High Yield Bonds" is represented by the ICE BofA High Yield Index calculated from annualized monthly data, except for the loss experience chart, where this is sourced from Moody's. "Leveraged Loans" is represented by the Morningstar LSTA US Leveraged Loan Index calculated from annualized monthly data, except for the loss experience chart, where this is sourced from Moody's. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. Represents loss rates for the COVID-to-Date period (Q1'20 to Q3'23). Default and Recovery rates are sourced from Moody's

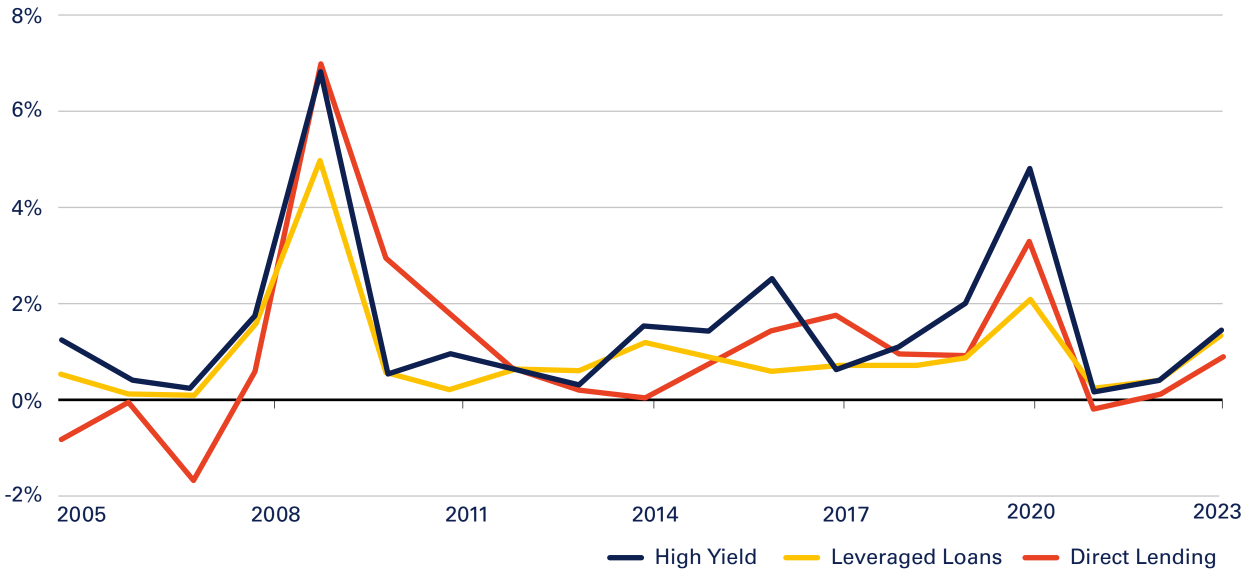
[18] Morgan Stanley, Understanding Private Credit, June 2024. https://www.morganstanley.com/ideas/private-credit-outlook-considerations

[19] J.P. Morgan, Four reasons to consider private debt despite the headlines, April 2024 https://privatebank.jpmorgan.com/eur/en/insights/markets-and-investing/ideas-and-insights/four-reasons-to-consider-private-credit-despite-the-headlines

Figure 16 shows the average post-default valuation of direct lending, syndicated loans, and high yield bonds in the twelve months leading up to defaults for the twelve months ending March 2024.

The research from J.P. Morgan Private Bank also finds that direct lending losses (after adjusting for recoveries) track losses on high yield bonds and leveraged loans (Figure 17). Notably, direct lending losses have been lower than leveraged loans and high yield loans during the post-COVID-19 period.

Figure 17: Direct lending losses match high yield and leveraged loans, annual credit losses by asset class (%) (U.S.)



Source: Cliffwater, J.P. Morgan Private Bank. Data as of December 31, 2023.[20]

[20] J.P. Morgan, Four reasons to consider private debt despite the headlines, April 2024 https://privatebank.jpmorgan.com/eur/en/insights/markets-and-investing/ideas-and-insights/four-reasons-to-consider-private-credit-despite-the-headlines

Industry participants generally attribute lower defaults and higher recovery rates of direct lending to active asset management, in which managers monitor each portfolio company's performance closely and are in frequent contact with management teams. This contrasts with syndicated loan managers that do not monitor individual loans in the same way and gives direct lenders an edge in their ability to address emerging issues quickly. Table 6 reflects Pemberton's approach to the best practices direct lending managers adopt.

Table 6: Pemberton's case study of direct lending monitoring

Monitoring
To facilitate the regular monitoring of portfolio assets, deal teams receive monthly financial reporting from portfolio companies, including income statements, balance sheets and cash flow statements. Monthly financials are analysed and compared to management budgets and GPs' base case scenarios. The main factors that the credit analysts monitor include:

- Operational performance (sales, EBITDA, etc.)
- Capital structure (leverage, RCF drawings, etc.)
- Liquidity (cash flow measures)
- Any other KPI / industry metric relevant to the portfolio company

Management
Investments showing material deviation from expected base case performance are subject to enhanced monitoring. Monthly monitoring allows deal teams to identify deviations in performance early and work with the borrower and shareholder(s) to take corrective action before more serious issues arise.

Criteria for this enhanced monitoring are a material deterioration in the risk-return profile of the investment but where no specific or significant intervention from the GP is required. Examples of factors that may indicate a material deterioration in the risk-return profile of an investment include:

- Weakening sales and/or EBITDA underperformance vs base case over several months / quarters (eg. EBITDA being > 10% off Pemberton's base case)
- Tight liquidity, and/or significant deterioration in working capital position
- Significant rating downgrades[21]
- Tightening of covenant headroom
- Loss of a major contract, market share and/or change in competitive dynamic
- Erosion of equity cushion underpinning the senior debt position
- Poor industry / sector outlook
- Serious governance issues

If a potential covenant breach is identified through monthly monitoring or by the borrower, the deal team will negotiate with the borrower and/or shareholder either to prevent / cure the potential breach or to propose a covenant waiver. Proposed covenant waivers or resets must be approved by Pemberton's Credit Review Committee in the same way as a new portfolio investment.

Classifications
"Watchlist" classification
Investments that are substantially underperforming the GP's Base Case and/or where the issues are likely to require significant actions by the GP are moved to "Watchlist" status. "Watchlist" assets are typically still able to meet payment obligations but may require concessions such as contract amendments. This category could also include underperforming assets where the GP is working alongside a sponsor that is providing financial support and/or operational intervention and oversight.

"Restructuring" classification – intervention to protect investment value
Restructuring assets will generally not require immediate acceleration and enforcement of security. However, the situation will call for active intervention by the GP which may include a balance sheet and/or operational restructuring. Consensual debt to equity conversions might also fall into this category, along with cases where a court process is used to enable the company to continue as a going concern.

"Recovery" classification – implementation of a strategy to minimise loss on exit
Investments where a balance sheet restructuring has been completed are moved from "Restructuring" to "Recovery" status. Consensual restructurings usually offer the best route to protecting value so GPs would seek to work alongside the management team and other lenders in these circumstances. If GPs and other stakeholders have differing view of the best route to recovery, GPs will always prioritise the interests of their investors. Where portfolio companies have required restructuring or additional support, GPs may ask for board representation and/or deploy other resources to ensure the recovery plan is executed.

Source: Pemberton

[21] As part of its credit assessment, Pemberton undertakes a rigorous analysis of the credit fundamentals of potential borrowers, including the calculation of an indicative obligor rating obtained using an Advanced Internal Ratings Based Approach (AIRBA) credit rating model, which estimates a one year probability of default for each potential investment.

PART 4
Sustainable Investing in Private Debt

Overview

Sustainable Investing, also referred to as ESG Investing, requires investors to consider environmental, social and governance factors in their investment decision-making, portfolio management and practices to the extent they are deemed to be material to financial performance. It may involve investment solutions that aim to achieve positive impact as well as financial return.

This assessment of sustainability and governance issues is supplemental to fundamental credit analysis and may be undertaken by a specialist sustainable investing team and/or embedded into an investment team's processes.

Private debt has historically received far less attention than public markets (equities and fixed income) and even private equity as a channel for sustainable investing. However, as the asset class has grown and gained influence, both GPs and LPs have started to look at using ESG integration to enhance risk management and value creation in private debt.

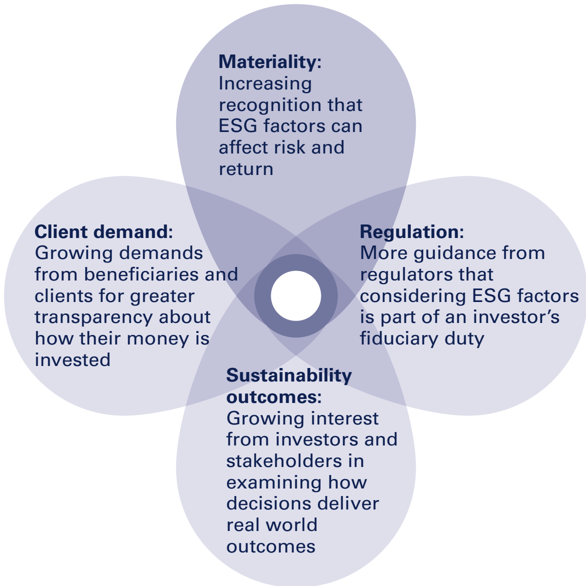
Alongside this growing investor demand, other factors are adding to the momentum behind sustainable investing:

- Opinions on what constitutes a good risk-return proposition have evolved as the relevance and materiality[22] of ESG issues have become more widely understood;
- Regulators have required greater transparency and accountability, particularly in Europe. Regulations such as the UK's Sustainability Disclosure Requirements (SDR) and the EU's Sustainable Finance Disclosure Regulation (SFDR) are designed to close "say / do" gaps;

Taken together, these factors have focused the attention of investors and asset owners more firmly on applying an ESG lens to investing.

UN PRI highlights the following drivers of responsible investing (Figure 18).

Figure 18: UNPRI's Drivers of Responsible Investing



Source: UN PRI: A Guide for Private Debt Investors, 2023[23]

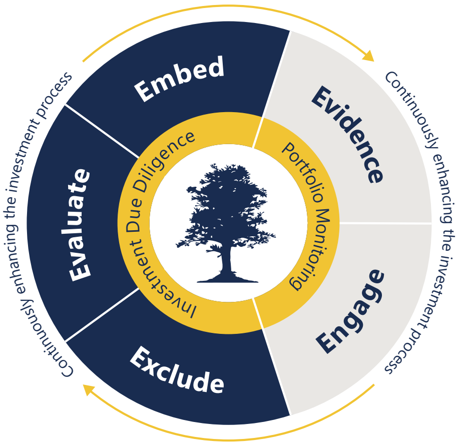
[22] Material sustainability factors are defined as issues identified as having, or the potential to have, a substantial impact on an investment's ability to generate or maintain economic value over time.

[23] https://www.unpri.org/private-debt/esg-incorporation-in-direct-lending-a-guide-for-private-debt-investors/11772.article

What Good ESG Integration Looks Like

While sustainable investing is gaining traction in private debt, asset managers are at different stages of their ESG integration. More advanced managers have a systematic approach for consideration of material governance and sustainability factors. Figure 19 illustrates Pemberton's ESG value creation framework.

Figure 19: Pemberton's ESG value creation framework



Source: Pemberton Sustainable Investing Report 2023-2024[24]

In the first instance, investments may be **declined or excluded** if their core business activities are inconsistent with the firm's sustainable investing objectives. Tobacco companies, for example, may be excluded on the basis that their products are harmful and addictive.

Integrating ESG factors into the investment process for private debt involves **evaluating** potential borrowers' sustainability practices and considering the implications for their risk-return profile. Due to the illiquid nature of this asset class, investors focus acutely on the sensitivity of a borrower's cashflows to adverse shocks, including those resulting from ESG risks. Consequently, there is growing recognition that embedding ESG analysis in the investment process helps to identify and ultimately reduce downside risk. But consideration of ESG factors can also provide valuable insights into the long-term upside potential of a company, for example environmental regulation that can strengthen the investment case for its products or services. From a governance perspective, investors will examine the management team's stewardship of the business, including their record of addressing risks and opportunities arising from the underlying business and market conditions. These will include social and environmental trends that are shaping industries and economies.

An important lever in private debt to incentivise progress and **embed sustainability performance** is the use of ESG-linked margin ratchets. This pricing mechanism reduces the interest margin payable on a loan if the borrower achieves agreed targets such as reduced carbon emissions. Some deals incorporate a "two-way" ratchet that increases the interest margin if the borrower does not take action. ESG margin ratchets represent an important driver of three-way engagement between the business owner (often a private equity sponsor), the borrower and the private debt provider to agree ambitious but achievable targets.

More sophisticated private debt managers integrate sustainability considerations through the full investment cycle. Post-investment, they maintain ongoing contact with borrowers to identify any potential deterioration in the risk-return profile, including ESG-related concerns. Through active **engagement** managers can encourage borrowers to improve sustainability performance during the lifetime of the loan. Their scope to do this successfully naturally depends on their degree of influence, which is greatest when they are the sole or lead direct lender.

Advanced ESG integration also incorporates quantitative assessment of portfolio companies using a scoring framework. While ESG ratings are not a 'silver bullet' for assessing how well borrowers manage ESG factors, quantitative scoring on the E-S-G pillars (including regular measurement of the borrower's carbon footprint) enables meaningful comparisons between investments and helps in **evidencing** progress and outcomes to LPs.

Navigating Sustainable Investing Challenges

Despite the progress, challenges remain. Lenders grapple with issues such as inconsistent ESG data quality, varying measurement standards and opaque (or sometimes non-existent) reporting practices by private mid-market companies.

Like any other fundamental variable, data on ESG factors can help debt investors better assess an investment's potential risk-adjusted return. Yet investors seeking to manage ESG-related risks have long faced a major challenge: incomplete data. This problem is greater in private markets, where sustainability reporting by unlisted mid-market companies is in its infancy, relative to listed companies. The challenges for private mid-market companies include financial constraints, lack of expertise and the absence of any legal obligation to disclose.

To tackle this issue, investors can use tools such as ESG questionnaires for prospective borrowers and portfolio companies to build their internal capacity to gather ESG data. Individual managers' efforts are reinforced by collaborative investor initiatives[25] that encourage adoption of more consistent ESG metrics and information, enhancing transparency and comparability. Systematic data collection is essential to advance ESG integration, both to enable meaningful due diligence and ongoing monitoring of portfolio companies.

[24] Pemberton's Sustainable Investing Process Report 2023-2024 https://pembertonam.com/sustainable-investing/

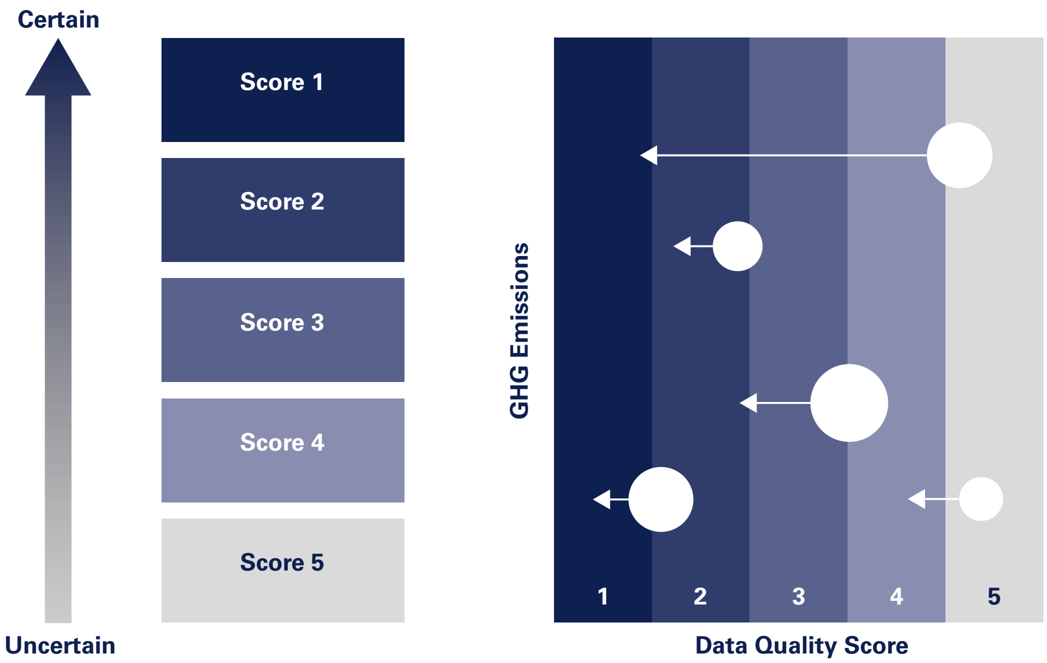
[25] For example. the ESG Integrated Disclosure Project (ESG IDP) for private credit, and the PE-led ESG Data Convergence Initiative (EDCI).

This data-driven approach also enables transparent disclosure. Robust datasets are vital to pre-empt accusations of 'greenwashing',[26] for example by providing incomplete or inaccurate information to regulators or investors. With some LPs increasingly calling on managers to set ambitious climate commitments such as a net zero decarbonisation pathway for portfolios, high quality data is essential to evidence progress towards these commitments.

Investor collaboration has led to asset-class-specific guidance that ensures a consistent industry-wide approach such as the Net Zero Investment Framework for Private Debt.[27] For this, carbon emissions data is required to measure both climate risk exposure and alignment to such frameworks. The ideal is to use reported emissions data calculated in line with the Greenhouse Gas (GHG) Protocol and collected from a verified third-party data provider. However, even when private companies do report their emissions, comparisons between them – even companies in the same industry – can be problematic because they often use different methodologies to make their assessment and include different information.

Encouragingly, tools and standards are being developed to help private investors fill the gaps in carbon data. For example, Partnership for Carbon Accounting Financials (PCAF) is a global standard that harmonises assessment and disclosure of greenhouse gas (GHG) emissions associated with loans and investments, as illustrated in Figure 20. This has enabled the emergence of third-party data estimation tools for private debt investors that include PCAF sector average benchmarks for carbon intensity. The sector average can be further adjusted by inputting revenue, headcount and geographic exposure to arrive at PCAF Score 4 level carbon emissions data estimates.

Figure 20: Financed Emissions: The Global GHG Accounting and Reporting Standard, PCAF



Source: Partnership for Carbon Accounting Financials (PCAF), December 2022[28]

In summary, while private debt investors must navigate challenges, innovation is enhancing best practices in sustainable investing for this asset class.

[26] In 2023, the European Securities and Markets Authority (ESMA) released what it calls a "high-level consensus definition" that defines greenwashing, intentional or not, as: "a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services. This practice may be misleading to consumers, investors, or other market participants."

[27] https://www.iigcc.org/hubfs/IIGCC%20NZIF%20Private%20Debt%20Guidance.pdf

[28] https://carbonaccountingfinancials.com/standard

Looking Ahead

Overall, the momentum behind sustainable investing will persist even though the enthusiasm for it that accelerated between 2017 and 2021 has eased somewhat, particularly in the U.S.

Within private debt, sustainable investing has taken hold more recently and is poised for further growth and refinement. Investors and fund managers will drive this process, aided by the development of standardised frameworks and metrics that will enable better ESG integration. We can also expect private debt managers to differentiate in this space, such as Impact Private Credit.

Impact investing is best defined as the deployment of capital with the intention of generating measurable and beneficial social or environmental outcomes alongside financial returns. Among the range of ESG approaches and strategies, it is the most ambitious because of this dual objective of financial performance and positive impact. Mid-market companies can provide solutions to societal and environmental challenges, while private debt investors can deliver economic value to established businesses that have the ambition to scale impactful products, services and business models.

The challenge is to ensure robust measurement of outcomes – but this is surmountable. Unlike private equity, private debt funds do not control the underlying businesses. However, companies refinance every 3–5 years and so lenders may hold more sway than many asset managers have traditionally thought. Managers can set ESG-linked terms in bilateral private debt deals, unlike publicly traded bonds, and hence can influence borrowers' behaviour and measurement of outcomes that demonstrate impact (although competitive dynamics in the market can and do have an effect).

Private debt's ability to generate impact is still a relatively new concept. Analysis[29] suggests that impact funds raised via private debt trail those raised via private equity, with the majority (65%) of private debt impact capital allocated to emerging markets. However, impact investing continues to expand and strengthen across asset classes – by October 2024 it had reached almost US$1.6 trillion AUM globally[30] – and it will also increase its presence in private debt.

In conclusion, having historically been considered a latecomer to sustainable investing, private debt is making up ground quickly. We can expect it to draw level with other asset classes in terms of best practice, integration and solutions in the near term.

[29] Based on one-fifth of estimated global AUM at $200bn, for GIINs market trend analysis

[30] GIIN: Sizing the Impact Investing Market 2024

PART 5
The Future of European Direct Lending

Direct lending, the largest strategy within the private debt market, continues to be attractive to investors even as the economic landscape shifts. As of 2024, direct lending funds in North America and Europe reached record assets under management levels of US$550 billion and US$380 billion,[31] respectively, with institutional investors, including pension funds and family offices, increasingly allocating capital to this sector. This trend is expected to persist, as 37% of limited partners indicate plans to increase private debt allocations,[32] encouraged by the high-interest-rate environment relative to the last decade.

However, challenges accompany this growth. As dry powder, or uninvested capital, accumulates, direct lending managers face increased pressure to deploy funds without compromising deal quality. In Europe, while dry powder levels have quadrupled in absolute terms since 2013, they have decreased as a percentage of AUM, reflecting success in deploying capital but also raising some concerns about maintaining returns as competition intensifies.

The nature of direct lending deals is also evolving. Private equity buyout deals, historically a significant source of direct lending opportunities, have slowed since 2021. The high interest rates relative to the last decade have shifted the focus from leveraged buyouts to add-on deals and recapitalisations, as companies prioritise strengthening existing operations over new acquisitions. This provides further opportunities for direct lenders to deploy capital.

In terms of risk, direct lending has proven resilient. During the COVID-19 pandemic, direct lending experienced lower losses than comparable leveraged loans, supported by proactive asset management practices that facilitate early intervention in struggling investments. This active management approach may position direct lending favorably in future economic downturns, although the anticipated further decrease in interest rates could slightly reduce returns.

In the long term, the future of direct lending appears promising, underpinned by institutional demand and the strategy's role in providing flexible financing to businesses. While a moderate decline in interest rates may reduce yields, direct lenders' ability to manage risk and maintain high recovery rates suggests resilience. The outlook remains positive, with direct lending likely to remain a core component of private debt strategies, adapting to economic shifts and continuing to attract investor capital.

31 Preqin Ltd, Historical Fundraising (cumulative), Direct Lending in North America and Europe, as of Q1 2025.

32 Coller Capital's 41st Global Private Equity Barometer, December 2024

PART 6
The Direct Lending Market – A Legal Perspective

LATHAM & WATKINS

KEY TAKEAWAYS

01

Growth and Flexibility of Private Credit: Private credit has become a vital alternative to traditional banking, offering sophisticated, flexible, and tailored financing solutions. This adaptability allows private lenders to meet specific borrower needs, especially in complex situations.

02

Convergence with Syndicated Loans: There is a growing alignment between private credit and syndicated loan markets, with private credit adopting similar covenant structures, pricing, and terms. This trend is driven by competition, the increasing pressure to deploy capital, the development of stronger relationships between private credit funds and private equity sponsors, and the need for flexible financing options, benefitting borrowers with more versatile solutions.

03

Liability Management Transactions: These transactions (which tend to be effected in the large cap end of the market) are increasingly used by financially distressed companies to access liquidity and restructure debt, predominantly in the United States but to some extent in Europe. They involve strategies such as ‘uptiering’ and ‘drop-downs’ to realign capital structures, often executed with the support of select creditors, but can lead to conflicts with nonparticipating creditors.

04

Changed European Restructuring Landscape: The introduction by key EU member states of new pre-insolvency restructuring regimes, which in many cases permit cross-class cram down of dissenting creditor and shareholder classes, has swung the pendulum towards value preservation through offering means to address financial difficulties at an earlier stage. These tools, coupled with the English scheme of arrangement and the enhanced English restructuring plan, present debtors and creditors with a wider choice of restructuring remedies.

Introduction

Since the global financial crisis, private credit has evolved into a well-established asset class, becoming a crucial alternative lending source as traditional banking faces increased constraints. In 2023, the economic landscape in the U.S. and Europe was characterised by inflationary pressures and elevated interest rates, leading investors to seek liquidity and underwriting flexibility beyond public markets. This shift has fuelled a surge in demand for private credit solutions, highlighting the versatility and unique value proposition that private lenders offer to borrowers.

Private lenders are increasingly favoured for their sophistication, flexibility, and certainty of execution, providing essential support in challenging environments. They often focus on assets or structures too complex for traditional lenders, employing innovative strategies to manage risks effectively. The flexibility of private credit extends beyond financial terms, encompassing a wide array of strategies across the capital structure and product types, from senior secured loans to junior unsecured credit and other hybrid capital instruments. This adaptability allows private lenders to tailor solutions to meet the specific needs of borrowers, offering customised financing options that are often unavailable through traditional banking channels.

Despite the strong performance of private credit markets, the broadly syndicated loan markets remain competitive in pricing. Many borrowers are now pursuing dual-track processes, a common feature in recent leveraged buyouts, negotiating between syndicated banks and private credit funds. This approach allows borrowers to leverage the strengths of both markets, optimising their financing strategies to achieve the best possible terms. Banks are also entering the private credit space, with several joint ventures announced recently. However, execution challenges persist as banks strive to match the speed and flexibility that distinguish private credit. The agility of private lenders often gives them an edge, enabling them to close deals more swiftly and efficiently.

As private credit increasingly finances larger transactions, terms are becoming more aligned with those of broadly syndicated loans. This convergence is indicative of the growing maturity and acceptance of private credit as a mainstream financing option. The comparative table below details the differences and convergences between the syndicated loan and private credit markets, including a summary of high- yield bonds for comparison. This evolution reflects the dynamic nature of the financial landscape, where private credit continues to play a pivotal role in meeting the diverse needs of borrowers and investors alike. As the market evolves, private credit is poised to remain a vital component of the global financial ecosystem, offering innovative solutions and driving growth in an ever-changing economic environment.

Convergence of Private Credit Terms with Syndicated Market Terms

In recent years, there has been a noticeable alignment between larger private credit transactions and the broadly syndicated loan market. Historically, these two markets catered to distinct borrower needs. However, a significant shift occurred in the past few years when bank lending nearly froze, prompting borrowers to turn to private credit providers. These providers stepped in to offer the financing and liquidity traditionally supplied by the broadly syndicated market. This growing convergence between direct lending and syndicated loans has resulted in an increase in covenant-light, club-style unitranche transactions, particularly for borrowers with strong credit profiles or reputable sponsors. The primary drivers of this trend include heightened competition among direct lenders, established sponsor precedents, and the substantial liquidity available in the market. We expect this trend to persist as private credit providers continue to compete with the broadly syndicated loan markets and seek to deploy the considerable funds that they have raised in recent years.

This convergence is evident in several key areas. Private credit agreements are increasingly adopting covenant structures similar to those found in syndicated loans. This includes looser incurrence covenants, with debt incurrence, restricted payment, and investment capacity mirroring the permissions in syndicated loans, along with more standardised documentation. Additionally, pricing and fees are becoming more aligned, with private credit deals now reflecting similar interest rate spreads and upfront fees as their syndicated counterparts. However, a PIK toggle remains a differentiating factor in private credit details. Prepayment terms are also becoming more flexible, mirroring those in syndicated loans, with mandatory prepayments now limited to illegality, change of control, and excess cash flow (which has become increasingly rare on top-tier sponsor deals). Disposal proceeds, report proceeds, and insurance mandatory prepayments are now commonly excluded. Furthermore, financial reporting requirements are converging, with private credit agreements adopting the frequency and level of detail typical of syndicated loans, which often do not include monthly reporting or an annual budget. The treatment of synergies in private credit deals is also aligning with the syndicated market, with certain deals having a cap on synergies on a per-item basis rather than on an aggregate basis over a relevant period, and the absence of CEO / CFO certification requirements in top-tier private credit deals. This blending of terms offers borrowers competitive and flexible financing options. The table below provides a detailed comparison of the differences in the loan documents. A notable example of this trend is the increasing demand from private equity sponsors for greater flexibility from private credit lenders. These sponsors seek to enhance leverage after closing and M&A deals and are advocating for the inclusion of provisions typically found in high-yield documents. As a result, several unitranche and private credit deals with strong sponsors are now incorporating high-yield style covenant packages. This push for flexible terms in private credit deals is driven by the competitive landscape between the broadly syndicated loan and direct lending markets.

In summary, the alignment between private credit and syndicated loans is reshaping the financing landscape. As private credit providers continue to adapt and compete, borrowers benefit from more versatile and attractive financing solutions. This trend is likely to continue, driven by market dynamics and the ongoing evolution of borrower and lender needs.

Table 7: Differences in Loan Documentation Between Syndicated, Direct Lending, and the High-Yield Market

European syndicated loan market	Direct lending market	High Yield market
Capital structure		
• Senior Facilities typically comprising Facility B and Revolving Facility potentially alongside a separately documented Second Lien Facility or Notes issuance. Typically, no flexibility for Super Senior Revolving Facility if there is a term loan in the structure (i.e. only relevant where senior debt is in the form of Senior Secured Notes only.	• Senior Unitranche and Super Senior Revolving Facility and potentially a Delayed Draw Term Facility.	• High Yield Notes in Europe typically comprise either Senior Secured Notes, which would rank pari with a Senior Secured Loan, and/or Senior Unsecured Notes issued at a structurally subordinated level with subordinated guarantees. In the U.S., Senior Unsecured Notes with senior ranking guarantees are more common.
Pricing		
• Margin and upfront fees typically lower than in Direct Lending Market (although if the deal is subject to pricing flex, that difference may be reduced or, in some situations, even eradicated). • Occasionally deals can be subject to reverse pricing flex (whereby pricing decreases) due to investor demand.	• Margin and upfront fees typically higher than in the European Syndicated Loan Market (although less so in top tier sponsored / jumbo deals). • Ability to PIK Toggle may be included subject to certain conditionality including around how often it may be invoked.	• High Yield coupons are typically fixed rate, but from time-to-time a market opens for floating rate notes. Initial issuances of High Yield Notes are typically made at par or with de minimis OID, but occasionally issuances are made with more significant OID. • PIK notes are less common, but sometimes form a part of the capital structure either as an equity bridge or in regulated industries.
Documentation		
• English law facility agreement, often with New York law interpreted 'bond style' undertakings and events of default in large cap (and increasingly sponsor-backed midmarket) deals rather than LMA based undertakings and events of default. • Alternatively, LMA based English law facility agreement for all provisions (with no NY bond-style covenant / EoD schedule), but with more flexibility than Direct Lending Market and often with certain 'bond style' concepts incorporated within the parameters of LMA based undertakings and events of default.	• LMA based English law facility agreement often, in top tier and upper mid-market deals, with NY style 'incurrence covenants' similar to European Syndicated Loan Market (though generally on slightly tighter terms). • No flex provisions even in underwritten deals as no formal syndication of facilities. • Revolving Facility has separate enforcement rights but are subject to standstill period vis-à-vis the Unitranche Lenders in the Intercreditor Agreement.	• New York law indenture with 'incurrence' covenants.

European syndicated loan market	Direct lending market	High Yield market
Documentation continued		
• Underwritten deals are subject to 'flex' provisions such that certain underwritten terms may be amended if required by the underwriters for successful syndication. • Facility B and Revolving Facility rank pari passu and vote collectively for the purposes of enforcement (other than where enforcement is pursuant to a breach of the RCF-only springing financial covenant).	• Provisions are generally more restrictive for the borrower than in syndicated loan markets although terms are starting to converge with syndicated loan markets.	
Security package		
• Typically limited to shares, structural intra-group receivables and material bank accounts and, where available, floating charges – though increasingly this is becoming further limited in top tier deals (e.g. by excluding bank accounts, or by only requiring share security over shares in obligors where held by another obligor). Security interest over SPA receivables is not commonly included. • Typically includes 'covered jurisdiction' concept where guarantees and security only granted in limited list of pre-determined jurisdictions (or, less commonly, in all jurisdictions other than those which are named as 'excluded jurisdictions'). • Focus of security package is on 'single point of enforcement' at the top of the banking group where creditors would likely enforce in a distressed scenario (rather than on asset security from the operating companies).	• Similar to European Syndicated Loan Market. • Similar to European Syndicated Loan Market with 'covered jurisdiction' concept. • Similar to European Syndicated Loan Market with focus on 'single point of enforcement'.	• For Senior Secured Notes, as per European Syndicated Loan Market. • Senior Unsecured Notes may benefit from key share pledges and structural intra-group receivables but are otherwise unsecured. • Escrow deals for secured notes typically also benefit from a security interest in the escrow account until escrow release.
Debt Incurrence		
• Broad permissions to incur debt which can be documented either as additional facilities within the Facilities Agreement or as side car debt.	• Typically, only permits additional senior secured facilities documented within the Facilities by an accordion (subject to a right of first offer / right of first refusal) and no side car debt although side car debt is becoming more common on top-tier sponsor deals.	• Broad permissions to incur debt which may be additional senior secured notes or senior secured facilities through a combination of a ratio basket (FCCR and/or leverage ratio) and 'Permitted Debt' baskets.

European syndicated loan market	Direct lending market	High Yield market
Debt Incurrence continued		
• Permits senior (pari), second lien, unsecured, and debt secured on assets that do not secure the Senior Facilities subject to specified baskets and ratios, most commonly following bond-style debt and liens covenant parameters (including the incurrence of acquired / acquisition debt subject to a 'no worse leverage' test).	• Permits senior, second lien, and debt secured on assets that do not secure the Facilities. • Negative pledge restricts granting of security over assets in customary manner. • While deals do permit acquired / acquisition debt, they are subject to a requirement to refinance it within certain timeframes or can only keep such debt outstanding if a leverage-based test can be complied with.	• Secured debt (secured pari on the collateral for Senior Secured Notes, and any secured debt for U.S. Senior Unsecured Notes) is typically subject to an additional secured leverage ratio, whereas European Senior Unsecured Notes typically permit any debt properly incurred to be secured. • For Senior Second Notes, second lien (on the collateral) is typically not included in the primary debt incurrence test. • Debt secured on assets that do not secure the High Yield Notes is typically limited to specified Permitted Debt baskets, with an additional (historically) modest 'Permitted Liens' basket. • High Yield Notes typically permit acquired / acquisition debt subject to a 'no worse (FCCR or secured leverage)' test, as applicable for the type of debt being incurred.
Restricted payments		
• Typically includes a permission to make Restricted Payments from a 'bond style' consolidated net income-based builder basket (often with a starter basket in top-tier sponsor deals), an Available Amount builder (which may include, among other limbs, permitted indebtedness and asset sale proceeds not required to be prepaid) subject to compliance with a leverage-based test as well as certain other 'Permitted Payment' and 'Permitted Investment' baskets.	• Similar to European Syndicated Loan Market.	• Typically includes a 50% of consolidated net income builder basket, or for telecom and certain other credits, an EBITDA - 1.4 / 1.5 x interest expense builder basket, in each case with additional 'Permitted Payment' and 'Permitted Investment' baskets. Builder baskets are typically subject to a FCCR test and may included a zero floor or a starter basket (either dating back to a prior issuance or as a further general basket).
Acquisitions		
• Typically, no (or very minimal) conditions to Permitted Acquisitions such as no Event of Default and no breach of sanctions undertaking.	• Similar to European Syndicated Loan Market.	• No restrictions on acquisitions provided the entity becomes a 'Restricted Subsidiary'.
Baskets		
• Typically include full flexibility to reclassify between baskets and 100% carry forward / carry back.	• Similar to European Syndicated Loan Market with the ability to reclassify baskets, and 100% carry forward / carry-back though super grower baskets / high watermarking are less common (and highly resisted).	• Typically include full flexibility to reclassify between baskets, but with only limited carry forward for specified baskets. • Baskets (including, increasingly Events of Default) typically subject to EBITDA growers.

European syndicated loan market	Direct lending market	High Yield market
Baskets continued		
• Baskets (including Events of Default) typically subject to EBITDA growers, sometimes with super grower / high watermark flexibility. • Where 'bond style' undertakings are included, Obligor / non-Obligor restrictions are uncommon, though in some deals non-guarantor debt incurrence under certain baskets may still be capped.	• Typically include Obligor / non-Obligor restrictions.	• Obligor / non-Obligor restrictions are only relevant for the debt incurrence covenant, where nonguarantor debt under certain debt baskets is typically capped.
Mandatory prepayment		
• Limited to illegality, Change of Control, asset sales, and Excess Cashflow (though note that the latter two requirements are qualified by broad reinvestment rights, and leverage-based ratchets). May also include listing, insurance and recovery proceeds, though these have become less common. • Change of Control definition often 'bond style' so is triggered only if a shareholder other than the original shareholders hold more than 50% of shares in the group (rather than by the original shareholders ceasing to own more than 50% of the shares in the group).	• Also occasionally includes disposal proceeds although there is usually flexibility to reinvest proceeds in the business rather than make a mandatory prepayment. • Change of Control definition often 'loan style' so is triggered by the original shareholders no longer owning more than 50% of the shares in the group pre-IPO and 30% of the share in the group post-IPO.	• Limited to an offer at 101% in the event of a Change of Control and an offer at 100% using Excess Proceeds under the Asset Sale covenant, and for escrow deals, a Special Mandatory Redemption if escrow breaks. • Change of Control definition typically triggered by a shareholder other a Permitted Holder holding more than 50% of voting control in the group or a transfer of all or substantially all the assets to a Person other than a Permitted Holder.
Call Protection		
• Typically, only included for 6 / 12 months post-closing at 1% (often based on margin rather than yield) in respect of repricings only and subject to carve-outs for certain transformative transactions.	• Call protection customary for one to two years post-closing in respect of voluntary prepayments and Change of Control.	• For standard, fixed coupon High Yield Notes, typically 'non-call' for two years for a five-year tenor, or three years for a seven-year tenor, during which period bonds may only be called if an expensive make whole premium is paid. • During the 'non-call' period, up to 30-40% may be called with the proceeds of an 'Equity Offering' (which may or may not require a true public offering) at a price equal to par plus the coupon. • May also include a feature whereby 10% per year may be called at 103% of par during the 'non-call' period. • After the 'non-call' period, High Yield Notes are callable at a premium set as a percentage of coupon, stepping down rateably to par prior to maturity.

European syndicated loan market	Direct lending market	High Yield market
Call Protection continued		
		• Floating rate notes typically have a circa one year 'noncall' periods and less expensive call premiums thereafter.
Financial Covenant		
• Typically, flat senior secured net leverage financial covenant for the benefit of the Revolving Facility only and only tested if the Revolving Facility is cash drawn above a certain proportion (e.g. 35–40%). • Equity cures (4-5 of which may take the form of EBITDA cures; remainder must be net debt or prepayment cures), deemed cures and, in some cases, recalculation cures generally permitted. No restriction on overcures.	• Typically, total net leverage financial covenant for the benefit of the Unitranche Facility and separate total net leverage financial covenant for the benefit of the Revolving Facility with c.10% headroom to the financial covenant that the Unitranche Facility benefits from. Covenant requires de-levering over the course of the life of the Facility Agreement before flatlining. • 4 equity cures typically permitted although sub-limit on number of EBITDA cures that may be made (if any).	• None.
Synergies		
• Typically capped on an aggregate basis in a relevant period (25% LTM EBITDA is most common) and subject to a look-forward (most commonly, for 24 months) and to certain certain carve-outs (e.g. for items specified in the model or relating to R&D). • Unusual to see CEO / CFO certification requirement or DD requirement where synergies exceed a certain percentage of EBITDA.	• Capped on an aggregate basis in a relevant period. • Typically include CEO / CFO certification requirement and/or DD requirement where synergies exceed a certain percentage of EBITDA although this is a feature which is seen less on top-tier sponsor deals.	• Sometimes uncapped or capped at circa 25% of EBITDA, and often with a 12 to 24-month time horizon for implementation. • No CEO / CFO certification requirement.
Reporting		
• Annual and quarterly financial statements, plus (in some cases) annual lender presentation / call and annual budget. Monthly financials are less common. • Reporting requirements may reduce / consolidate if the group issues a bond or lists.	• Typically, 'loan style' reporting including monthly financial statements and delivery of an annual budget.	• No requirement to provide monthly financial statements or annual budget. • Some deals document a requirement for calls.
Amendments		
• Majority Lenders: 50.1% (or, less commonly, 66⅔%). • Super Majority Lenders: 66⅔% (or, less commonly, 80%).	• Majority Lenders: 50.1% (or, less commonly, 66⅔%). • Super Majority Lenders: 66⅔% (or, less commonly, 80%).	• Most amendments require 50.1% of aggregate principal amount.

European syndicated loan market	Direct lending market	High Yield market
Amendments continued		
• No separate consent rights for Revolving Facility other than with respect to the springing financial covenant. • Given large number of lenders, consent process typically more difficult than direct lending market.	• Revolving Facility Lenders have separate consent rights to preserve super senior nature of the facility such as disposals over a certain percentage of EBITDA, amendments to the Facility Agreement to permit further super senior debt or rights that are just for the benefit of Revolving Facility Lenders. • Relatively straightforward consent process given Unitranche Lenders typically constitute Majority Lenders for the life of the Facilities.	• In Europe, specified amendments require 90%, except for release of all or substantially all the security and guarantees, which may require as low as 75%. • In the U.S. and Asia, specified amendments often require 100%, but the 90% threshold is becoming more common. • Given large number of holders, consent process is passive and generally involves use of an investment bank agent – most common consent topic is COC.

Liability Management Transactions

Liability management transactions that utilise covenant flexibility to enable companies and sponsors to access additional liquidity when facing financial distress, are becoming increasingly common in the U.S., leveraged finance markets, significantly influencing European practices, although European examples of actually completed liability management transactions are rather limited.

As these transactions gain momentum, creditors must devise strategies to protect themselves from potential adverse outcomes, including situations where existing creditors are pitted against one another. For financially stressed debtors, liability management transactions present an appealing option, allowing for refinancing or additional borrowing that might otherwise be inaccessible. Creditors involved in these transactions often benefit economically from both new instruments and their existing investments. Two primary types of these transactions are 'uptiering' and 'drop-downs'.

Uptiering involves a borrower incurring new priority debt or improving the prior of an existing tranche of debt. Typically, this involves a subset of existing lenders providing the additional "super priority" financing whilst consenting to the necessary amendments under the existing debt in order to prioritise the new debt. This process may include rolling up existing creditor debt into a facility that is senior to the remaining debt but junior to the new tranche. Drop-downs, on the other hand, allow a borrower to move assets outside the restricted group, using them as collateral for new borrowing that is structurally senior to the original financing. Recently, drop-down transactions have evolved to enhance credit support for new lenders. This is achieved by offering a receivables pledge over an intercompany loan from the unrestricted subsidiary borrower to the existing credit group (funded using the proceeds of the new structurally senior financing). Additionally, guarantees of the new debt may be provided by the existing credit group or by entities outside the existing credit group – these transactions are commonly known as "double dip" transactions.

Liability management is gaining traction as a viable strategy. Once considered unfavourable, liability management transactions are now seen as a legitimate alternative for private companies and their sponsors facing near-term financial challenges, such as liquidity issues or upcoming maturities. These transactions can also lay the groundwork for comprehensive, long-term financial restructuring. Although the term "liability management" can encompass a wide range of restructuring transactions, in this context, it refers to a borrower's efforts to realign its capital structure by collaborating with select creditors and stakeholders to issue new senior secured indebtedness within the confines of existing financing documents.

For years, low interest rates and other factors fostered fierce competition among financial creditors, giving borrowers significant bargaining power and diluting market-standard creditor protections. Borrowers used this leverage to (1) roll back restrictive loan provisions that prevented them from moving collateral outside the credit group and (2) reduce voting thresholds for amendments to material structural protections. However, the current market is characterised by higher interest rates, persistent inflation, and the lingering effects of global turmoil. Many private companies now face operational and financial challenges in a complex post-pandemic environment with a tighter credit market. Where only limited refinancing or restructuring options are available, borrowers are turning to liability management transactions to extend their financial runway and avoid imminent bankruptcy, or to set the foundation for lasting financial reorganisation.

The typical liability management transactions situation involves a struggling borrower identifying how to exploit existing financing documents to unlock value and secure new money financing without triggering unanimous creditor voting requirements, pro rata sharing provisions, and other creditor protections. The borrower then builds a coalition of supporting creditors and stakeholders willing to provide fresh capital, refinance with discounted paper, or offer better credit terms in exchange for a superior position in the borrower's capital structure and enhanced recovery expectations. Liability management transactions are often executed over the objection of non-participating creditors, who may see their collateral base or lien priority erode almost overnight. This can lead to litigation between participating and non-participating creditors, highlighting the need for creditors to remain vigilant and proactive in protecting their interests. Private credit funds are uniquely positioned to provide liquidity in liability management transactions due to their flexible underwriting capabilities. Unlike traditional lenders, private credit funds can tailor their financing solutions to meet the specific needs of borrowers, offering bespoke terms and structures that align with the unique circumstances of each transaction. This flexibility allows them to quickly adapt to changing market conditions and borrower requirements, providing timely and efficient capital solutions.

There are various reasons for the less developed liability management transaction environment in Europe. Documentation is different and there is more likelihood of elements of priming and roll up transactions requiring all lender consent. Intercreditor agreements in Europe can be less permissive of unequal treatment within creditor classes. There can be greater restrictions on debt purchases with a subset of lenders. Local laws may also be more protective of minority rights in creditor groups and directors' duties may affect a board's decision making on what is in the interests of the company concerned. U.S. transactions have been significantly litigated, and unlike in England there is no "loser pays" costs doctrine in the U.S. to disincentivise transactions which could result in litigation. Finally, the market is smaller than the U.S. and sponsors / companies may be less likely to take action considered very aggressive.

The best-known example of a liability management transaction in Europe to date is Hunkemöller which was a high yield bond transaction where a group of bondholders holding a voting majority of the Senior Secured Notes were asked to amend the SSN's priority of payments and exchange new SSNs into "elevated first out" SSNs in return for providing new money. The transaction is being challenged in the U.S. courts by members of the bondholder group left in the existing SSNs on the grounds of breach of contract and the implied duty of good faith owed to bondholders. There may also have been issues under Dutch directors' duties laws which could face scrutiny if the company's position were to deteriorate further into bankruptcy.

Finally, the use of co-operation agreements between bondholders is growing in Europe in order to resist the unequal treatment of creditors and to block unfavourable restructurings and present a united front in negotiations.

Changed European Restructuring Landscape

The European restructuring and insolvency landscape has historically been fragmented when contrasted with the unified framework of the U.S. Bankruptcy Code. This has led to legal uncertainty and often heavily bespoke restructuring solutions for cross-border groups. That landscape has been transformed in recent years by the implementation of each member state's variation of the EU Directive on Preventive Restructuring Frameworks (2019 / 1023). The Directive had the underlying policy intention of harmonising restructuring laws through the introduction of national frameworks to allow companies facing financial distress to restructure their financial liabilities at an earlier stage outside of the stigma of insolvency proceedings. While not offering a single common platform such as a U.S. Chapter 11 bankruptcy, the separate national frameworks are intended to provide a conceptual pre-insolvency consistency across the EU jurisdictions. The table below provides a detailed comparison of the key principles and features of the principal restructuring process in a number of key EU jurisdictions as well as England and Wales, and Norway.

The UK already had the English scheme of arrangement which, over the previous decade and a half, had become the restructuring tool of choice for European groups able to find the necessary connection to engage its jurisdiction. However, the scheme critically lacked the ability to cram down a dissenting creditor or shareholder class, so granting an effective right of veto to an opposing class of creditors or shareholders. The adoption of the English restructuring plan in 2020 filled this gap, permitting an equity and debt restructuring to take place in situ under one single overarching process.

European debtor groups and their creditors now have a panoply of potential restructuring tools at their disposal and many of these nascent procedures are being used in practice. Any expectation that debtors would post-Brexit migrate from the tried-and-tested English compromise tools has been only partly borne out. The attraction of an experienced judiciary and mature jurisprudence (based on its scheme of arrangement cousin) has allowed the English restructuring plan to be used to restructure European-based groups and also trans-Atlantic groups seeking a less costly alternative to Chapter 11. The lack of a strict absolute priority rule under the English restructuring plan has opened creative new restructuring avenues to U.S.-based groups that would not necessarily be available in the U.S.

The German StaRUG and Dutch WHOA have quickly become the early trailblazers for the new EU regimes, each being used in complex cross-border cases and having the benefit of automatic recognition within the EU under the European Insolvency Regulation (for their respective public versions). A healthy competition exists between the new European processes and one size does not fit all. Debtors and their advisers (often in co-operation with supportive creditors) need to perform a more complex jurisdictional comparison exercise than in the past. The proliferation of choice has made this exercise harder. A holistic restructuring is one that is enforceable across borders and this may involve parallel proceedings.

The prominence of English law debt in the international loan and capital markets presents a limiting effect on use of the EU processes alone. This is due to the so-called "Rule in Gibbs" which says that, as a matter of English law, only the governing law of a contract may validly discharge or amend it. In practice, the rule applies predominantly to creditors with English law governed claims so that- absent the agreement of the creditor- debts may be validly discharged or amended only by an English law process.

Failing to address an English law angle to an EU restructuring may therefore leave the restructuring vulnerable to challenge by opposing creditors, in particular where there are assets subject to the English court's jurisdiction to which any unrestructured claims could attach. To deliver a holistic restructuring, it may be necessary to run a parallel English process to address English law governed claims in tandem with the primary restructuring tool (see, for example, the Vroon and Cimolai cases in which an English scheme and restructuring plan respectively played second fiddle to Dutch and Italian processes to compromise English law governed debt, and McDermott in which a Dutch WHOA for Dutch incorporated holding company borrowers sat alongside an English restructuring plan for the main operating company), which had in an earlier round of restructuring used Chapter 11 without delivering the holistic restructuring solution the group subsequently required).

Although the UK Insolvency Service has indicated a willingness to revisit the Rule in Gibbs in the context of the UK's future implementation of the UNCITRAL Model Law on Insolvency-Related Judgments, the complexities made apparent from its consultation have prompted a return to the drawing board to settle the UK's position. As it cannot be described as a legislative priority, this may take considerable time and protracted debate to resolve. The need to compromise English law governed debt with an English process will therefore remain, at least for the medium term.

Separately, the UK government has announced that it intends to legislate to adopt the UNCITRAL Model Law on European Group Insolvency at the earliest opportunity. Its purpose is to co-ordinate cross-border insolvencies within corporate groups while respecting separate legal entities. It will allow for procedural co-ordination but will not extend to substantive consolidation. The UK may very well be the first country to adopt the law. As such, the impact is expected to be limited at least in the medium term until a critical mass of states have similarly adopted the Model Law.

As the various new restructuring processes have bedded down, a number of common themes have emerged across the different regimes and jurisdictions:

- **Retention of equity:** are there absolute or modified priority rules that restrict the ability for junior creditor or shareholder classes to make any recovery when classes senior to them are impaired? Are providers of "new value", for example, excepted from such rules? More specifically, what contribution to the restructuring do shareholders need to make in order to retain their equity in circumstances where higher-ranking creditors are impaired under the plan? Can in-the-money creditors "gift" equity back to the shareholders in a departure from the applicable priority rule, as is sometimes seen in U.S. Chapter 11 cases as an exception to its absolute priority rule.
- **Apportionment of the 'benefits preserved or generated by the restructuring' (or the 'restructuring surplus'):** what test should be applied in determining the fairness of the proposed distribution of the benefits preserved or generated by the restructuring (alternatively described as the 'restructuring surplus') between competing creditors? Should out-of-the-money creditors be offered anything more than nominal value? Is it permissible to treat similarly ranking creditors differently ('horizonal gifting' in U.S. parlance) and in what circumstances? Absent situations where they provide no "new value", should out-of-the-money creditors be excluded entirely from entitlement to the benefits preserved or generated by the restructuring? How will the courts apply the new law in practice?
- **Comparator:** critical to the question of fairness is the yardstick against which any restructuring plan is measured. Is this the expected return in a liquidation or some other going concern-based alternative? Should the expected future reorganisation value of the group be considered?
- **Valuation disputes:** how will the court act to resolve valuation disputes? Will it treat any such dispute as any other commercial litigation with the attendant costs and time which may be less available to a company in financial distress? How will it address the potentially unfair asymmetry of financial information available to the debtor and dissenting creditors? Does the regime provide for the appointment of an independent expert who reports to the court on valuation matters?
- **Third-party releases:** will the relevant restructuring proceeding permit the release or amendment of creditor claims against third-parties within the debtor group (for example, against guarantors) without the third party having to propose an separate parallel plan? Can releases be extended beyond the debtor group to benefit directors, officeholders and advisers from all parties to the transaction?
- **Creditor plans:** is a creditor group able to substitute a competing plan for the debtor's and what criteria does the court apply in determining which plan to approve? The Spanish restructuring of Celsa has provided an illuminating example of a creditor-led plan wresting control of the group away from opposing shareholders whilst in the UK, the Thames Water interim restructuring plan has illustrated the challenges faced by a subordinated dissenting creditor group in proposing an alternative plan that was limited in scope to offering different economic terms for the emergency funding required by the debtor group. Any counter-proposal requiring more detailed financial information from a debtor group faces enormous difficulty if opposed by the company and other key creditors.

All of these uncertainties introduce substantial litigation risk, which of course increases costs and timing delay. Where a restructuring requires parallel processes, the asymmetry between the regimes can result in implementation and timing uncertainty as well as providing multiple forums for creditor opposition.

The cumulative uncertainty may result in a flight to relative certainty through consensual out-of-court restructurings. Arguably, the threat of a court-based process may have performed its intended deterrent effect if it drives debtor, creditor, and shareholder behaviour towards a negotiated solution.

Comparison of European Restructuring Procedures[33]

Table 8: Overview

Jurisdiction	Date of introduction / frequency of use	Length of procedure[34]	Approval threshold (assuming no cross-class cramdown)	Cross-class cramdown	DIP financing available within procedure?
Denmark *In Court Restructuring (Indenretlig rekonstruktion)*	July 2022 (amending existing restructuring rules first introduced in 2011); commonly used (there has been increase in use since 2020 compared to the initial introduction of the Danish restructuring rules in April 2011)	7 months from appointment of a restructuring trustee, unless extended upon request (up to 11 months in total)	• Restructuring plan: adopted unless a majority of the creditors representing at least 25% by value vote against it • Restructuring proposal: adopted if a majority of the creditors by value, or a majority in number of each class, vote in favour of it	✓ Possible, provided the restructuring proposal is approved by either: • a majority of classes; or • one class which is in-the-money	×
Preventive restructuring process (forebyggende rekonstruktion)	July 2022 (implementation of Restructuring Directive)	Up to 12 months from launch	• If a debtor requests and the court imposes a moratorium, the plan can proceed without a creditor vote • However, a restructuring proposal can proceed directly and is adopted if a majority of the creditors by value, or a majority in number of each class, vote in favour	✓ Follows the same rules as a regular restructuring process as listed above.	×
England and Wales *Restructuring Plan*[35]	June 2020; 35 cases since introduction	2 – 3 months from launch	75% by value of each class	✓ Possible, provided the following conditions are met: • no creditor is worse off in the relevant alternative; and • the plan is approved by at least one in-the-money class with a "genuine economic interest" (applies to both creditor and shareholder classes)	×

[33] Key terms are defined in the glossary following this table

[34] Subject to court availability, relevant circumstances concerning the relevant restructuring and assuming no challenges to the restructuring procedure. Timeframe for the implementation phase for restructuring following approvals under restructuring procedures are further dependent on the contents and required steps for the relevant restructuring proposal.

[35] English schemes of arrangement are also used to effect restructuring proposals, but every class must approve (75% by value and majority in number without the possibility of cross-class cramdown), thereby giving any dissenting class an effective right of veto.

Jurisdiction	Date of introduction / frequency of use	Length of procedure[34]	Approval threshold (assuming no cross-class cramdown)	Cross-class cramdown	DIP financing available within procedure?
France *Accelerated Safeguard Proceedings (Sauvegarde Accélérée)*	October 2021; approaching 30 cases since introduction	2–4 months from opening judgment (but maybe significantly longer e.g. up to 12 months)	66⅔% by value of each class	✓ Possible, provided the following conditions are met: • the plan is approved by a majority of classes, with at least one being a class of secured or senior creditors; or by at least one creditor class in-the-money based on a going concern valuation; • the best interest of creditors test is satisfied in relation to all dissenting creditors; and • the plan adheres to the APR in relation to all dissenting classes, unless the court decides otherwise Additional criteria has to be met to cramdown equity holders	✗ Not strictly available, but post-petition new money required to fund the business will be given a relative payment priority status and other protections in a subsequent insolvency (no cram down possible)
Germany *Preventive Restructuring Process (StaRUG)*	January 2021; approximately 15 public cases since introduction, but the option of using it has been used successfully as a threat to push stakeholders toward a consensual solution in other cases	2+ months from launch	75% by value of each class	✓ Possible, provided the following conditions are met: • best interest of creditors test is satisfied; • the plan adheres to the APR with further and more detailed requirements; and • the plan is approved by a majority of classes, with at least one being a class of secured or senior creditors	✗ No DIP-like preference over existing financing / security, but new funding under the plan benefits from certain exemptions from claw-back in a subsequent insolvency
Italy *Composition With Creditors (Concordato Preventivo) – CWC*	Originally introduced by the Italian bankruptcy law (Royal Decree March 16, 1942) Recently renewed by the new Italian Insolvency Code (Legislative Decree 14 of 2019)	12 months from launch	• Either: (i) majority of the creditors by value; and majority of classes voting with approval threshold of 50%+1 by value of each claim; or (ii) 66⅔% by value overall, provided that the creditors voting on the plan hold at least 50% by value of the debt	✓ Possible in CWC with business continuity, provided the following condition(s) are met: • the plan adheres to the APR with regards to liquidation value, and adheres to the relative priority rule if the plan's value is higher; and	✓ Available subject to the court's authorisation and best interest test being satisfied

Jurisdiction	Date of introduction / frequency of use	Length of procedure[34]	Approval threshold (assuming no cross-class cramdown)	Cross-class cramdown	DIP financing available within procedure?
			• Specific voting rules apply depending on the type of the plan (i.e., business continuity vs. liquidation)	• the CWC is approved by the majority of classes, with at least one class being secured creditors; or • if neither of the above conditions are met, the CWC is approved by at least one class of affected creditors who would have been satisfied, in whole or in part, even if the APR had also been complied with regard to the value exceeding the liquidation value	
Luxembourg *Judicial Reorganisation (Réorganisation Judiciaire)*	November 2023; not widely used yet	Varies depending on the moratorium period set by the court, which is usually up to 4 months but can be extended to a maximum of 12 months if requested	Majority in value and majority in number of each class of unsecured creditors and secured creditors	✓ Possible, provided the following conditions are met: • the plan is approved by at least one of the classes of creditors eligible to vote; • if approved by ordinary creditors only, the plan treats extraordinary creditors more favourably than ordinary creditors; and • no class of creditor receives or keeps more than the total amount of its claims	✗
Netherlands *Dutch Scheme (Wet homologatie onderhands akkoord) – WHOA*	January 2021; approximately 60 WHOA plans have been submitted to the court for sanctioning, out of over 400 starting declarations deposited with the court	1 – 2 months from offering a final plan to creditors, but the timeframe may be longer due to interim relief requested from the court	66⅔% by value of each class that has voted	✓ Possible, provided the following conditions are met: • the plan adheres to the APR, with certain deviations permitted; • a creditor may not end up worse off pursuant to the plan than they would have been in the event of bankruptcy of the debtor; and • the plan is approved by at least one in-the-money class (based on liquidation valuation)	✗ However, the court can approve (i) interim financing and associated security rights; or (ii) other transactions ancillary to and necessary for the plan, approval of which protects against clawback in a subsequent insolvency

Jurisdiction	Date of introduction / frequency of use	Length of procedure[34]	Approval threshold (assuming no cross-class cramdown)	Cross-class cramdown	DIP financing available within procedure?
Norway *Company Restructuring Process (Rekonstruksjon)*	May 2020 (introduced under temporary legislation, which is expected to be repealed and replaced by permanent legislation in July 2026); 63 reconstruction cases since its introduction	2–6 months from launch	50% or more of unsecured debt (the plan is only binding on the unsecured portion of debt)	✗	✓ DIP financing is available. New money financing the operations of the debtor may be secured by a pledge over the debtor's inventory, operating assets and trade receivables with priority ahead of all existing pledgees, subject to consent from the reconstruction committee. Existing pledgees that will be affected by such new pledges may file a petition within the prescribe time to the court requestion that the reconstruction committee's consent is reversed. If the existing pledgees security is "significantly impaired", or the court finds that there is insufficient need for the new money financing, the court may reverse the reconstruction committee's consent
Spain *Restructuring Plan (Planes De Reestructuración)*	August 2022; around 200 plans for both large companies and SMEs sanctioned in 2023	6–7 months from launch	• 66⅔% by value of each unsecured class; • 75% by value of each secured class; • Special 66⅔% or 75% by value thresholds of syndicated debt class, unless the relevant syndicated loan provides for a lower value threshold	✓ Possible, provided either of the following condition(s) are met: • the plan is approved by a majority of classes, including at least a class of secured creditors; or • by one class which is in- the-money as evidenced by the restructuring expert's valuation Additional criteria has to be met to cramdown equity holders	✗ However, interim and new money financings provided in respect of a plan sanctioned by the court and compromises: (i) more than 51% of the total indebtedness of the debtor; or (ii) more than 60% of the total indebtedness of the debtor, if the interim or new financing is provided by a specially related person to the debtor, are afforded certain privileges in each case.

Jurisdiction	Date of introduction / frequency of use	Length of procedure[34]	Approval threshold (assuming no cross-class cramdown)	Cross-class cramdown	DIP financing available within procedure?
Sweden *Company Restructuring Process (Företags-rekonstruktion)*	August 2022; around 250 restructuring cases since introduction	8–12 months from launch	66⅔% in number of parties voting in each class, and 66⅔% by value of each class	✓ Possible, provided either of the following condition(s) are met: • the plan is approved by a majority of classes, including at least one class of secured creditors; or • by two classes which are in-the-money Additional criteria has to be met to cramdown equity holders	✓ DIP financing is available. The debtor can provide unencumbered property as collateral for interim and new financing with the collateral being protected against clawback. It is also possible to provide grantors of interim or new financing with priority in the context of a subsequent insolvency procedure ahead of creditors with a floating charge or unsecured creditors

Table 9: Legislative framework

Jurisdiction	Initiating Party	Eligibility	Automatic moratorium?	Court involvement?	Court-appointed supervisors?
Denmark *In-Court Restructuring (Indenretlig rekonstruktion)*	Initiated by a creditor or the debtor inside formal insolvency	• COMI in Denmark; and • The debtor must be facing insolvency, meaning that the debtor is unable to fulfil its obligations when due, unless the inability to pay can be assumed to be temporary	✓ Automatic stay on all insolvency petitions and enforcement actions; and prevention of automatic termination of executory contracts and debt acceleration	✓ The court is involved in: • opening the restructuring proceedings; • appointment of the restructuring trustee; • extension of deadlines; and • ratification of the restructuring plan that has been approved by a sufficient number of creditors	✓ One or more restructuring trustees are appointed to advise and supervise the debtor The application for restructuring proceedings is ineffective if it does not contain a proposal for the appointment of a restructuring trustee
Preventive restructuring process (forebyggende rekonstruktion)	Initiated by the debtor	The debtor must be insolvent or likely to become insolvent	✗ No automatic stay	✓ The court is involved in: • opening the preventive restructuring proceedings; • ensuring compliance with formalities and deadlines; and • assessing grounds for termination and deciding on termination if necessary	A restructuring trustee is only appointed if it is requested by the debtor or if the debtor applies to the court for a stay of proceedings

Jurisdiction	Initiating Party	Eligibility	Automatic moratorium?	Court involvement?	Court-appointed supervisors?
England and Wales *Restructuring Plan*	Initiated by the debtor either outside or inside formal insolvency (i.e., may be proposed by an insolvency officeholder, such as an administrator)	• Sufficient connection with England and Wales; and • The debtor must be facing actual / prospective financial difficulties which will be addressed by the plan	✗ No automatic stay but plan may be combined with administration stay (i.e., if initiated by the debtor in a formal administration proceeding) or, if applicable, a standalone moratorium	✓ The court is involved in: • approving class composition at first hearing; and • sanctioning plan at a second hearing following approval of affected creditors / shareholders	✗
France *Accelerated Safeguard Proceedings (Sauvegarde Accélérée)*	Initiated by the debtor at the end of prior conciliation proceedings (which must be pursued first)[36]	• Prior conciliation proceedings; and • Demonstration that the draft restructuring agreement entered into under conciliation is likely to receive sufficiently broad support from affected parties to make its adoption likely within the accelerated timeframe	✓ Automatic stay from the opening judgment which applies only against affected parties[37]	✓ The court is involved in particular in: • opening the accelerated safeguard; • appointing administrators and supervising judge who is granted specific powers; and • approving the adoption of the safeguard plan	✓ One or two administrator(s) (who are usually the former conciliators) are appointed to determine the constitution of the voting classes and assist with the preparation of the safeguard plan
Germany *Preventive Restructuring Process (StaRUG)*	Initiated by the debtor outside of formal insolvency	• COMI in Germany; and • The debtor must be facing financial difficulties but cannot be cash flow or balance sheet insolvent	✗ No automatic stay, but the court may order a moratorium on application by the debtor if certain conditions apply	✓ The court is involved in: • preliminary review of certain issues that affect the sanctioning of the plan or a moratorium if requested by the debtor; and • sanctioning of the plan	✓ Restructuring officer appointed (at the request of the debtor or holders of at least 25% by value of a voting class) to assess the likelihood of the restructuring succeeding or determining whether formal insolvency proceedings should be initiated instead
Italy *Composition With Creditors (Concordato Preventivo) – CWC*	Initiated by debtor facing crisis or insolvency risk (but prior to any formal insolvency declaration)	• COMI in Italy; • The debtor is a commercial enterprise; and • The debtor must be facing crisis or insolvency	✗ No automatic stay, but the court may order a moratorium and other protective measures (up to a maximum duration of 12 months) on application by the debtor if certain conditions apply	✓ The court is involved from the beginning of the proceedings and until the approval of the plan The debtor remains in possession of ordinary business but is required to seek authorisation for extraordinary transactions	✓ Court's officer (*commissario giudiziale*) is appointed to supervise on extraordinary transactions and regularity of the proceedings

[36] Conciliation proceedings, which are consensual, confidential proceedings between a company and its stakeholders under the supervision of a court-appointed supervisor to reach a restructuring agreement, may last for a maximum of 5 months and also can be opened in relation to insolvent debtors within 45 days of insolvency.

[37] In the case of regular safeguard proceedings, the stay applied against all of the debtors' creditors.

Jurisdiction	Initiating Party	Eligibility	Automatic moratorium?	Court involvement?	Court-appointed supervisors?
Luxembourg *Judicial Reorganisation (Réorganisation Judiciaire)*	Initiated by the debtor outside formal insolvency	• Financial difficulties / continuity of its business is threatened; and • The proposal is intended to restore the profitability and solvency of the business, implement a possible social plan and satisfy its creditors	✓ Automatic stay from the order for judicial reorganisation by the court	✓ The court is involved in a single hearing for adjudication of the judicial reorganisation	✓ Judicial representative appointed to assist the debtor with preparing a reorganisation plan
Netherlands *Dutch Scheme (Wet homologatie onderhands akkoord) – WHOA*	Initiated by the debtor outside of insolvency or by a creditor, shareholder or works council by seeking the appointment of a restructuring expert	• COMI (for public proceedings under the Recast EU Insolvency Regulation) or sufficient connection (for private proceedings outside of Recast EU Insolvency Regulation) in the Netherlands; and • The debtor must be facing actual / prospective financial difficulties (i.e., it must be reasonably likely that the debtor cannot meet its debts when they fall due)	✗ No automatic stay, but the court may order a moratorium on application by the debtor or a restructuring expert if certain conditions apply	✓ The court is involved in: • determining interim measures including appointment of the observer or restructuring expert and/or a moratorium; and • sanctioning the plan	✓ One court appointed supervisor can be appointed. This can be either: • An observer appointed to oversee the process and report to the courts (i.e., a procedural function only); or • A restructuring expert appointed to negotiate a deal with creditors in place of the debtor and who has the sole authority to offer plans to creditors
Norway *Company restructuring process (Rekonstruksjon)*	Initiated by the debtor who has, or in the foreseeable future will have, serious financial difficulties Initiated by a creditor if the debtor cannot fulfil its obligations as they fall due	COMI in Norway	✓ Automatic stay on all insolvency petitions and enforcement action (subject to very limited exceptions); and prevention of automatic termination of executory contracts and debt acceleration	✓ The court is involved in: • opening the restructuring process and, if requested, a separate restructuring plan process; and • confirmation of a restructuring plan that has been approved by sufficient numbers of creditors	✓ An administrator and a creditor committee are appointed to assist and advise the debtor during the negotiations on the reconstruction, as well as to look after the joint interests of the creditors

Jurisdiction	Initiating Party	Eligibility	Automatic moratorium?	Court involvement?	Court-appointed supervisors?
Spain *Restructuring Plan (Planes De Reestructuración)*	Initiated by creditor or debtor (typically debtor) outside formal insolvency	• COMI in Spain; and • Subject to fulfilling certain requirements, if a parent has its COMI in Spain, the plan may also be extended to subsidiaries whose COMI is elsewhere if they have common creditors	✓ Filing of the pre-insolvency communication[38] triggers an automatic stay on insolvency petitions and enforcement actions (subject to very limited exceptions); and prevents the automatic termination of executory contracts and debt acceleration based on the filing of the communication	✓ The court is involved in: • confirming proposed creditor classes; • the appointment of a restructuring expert; • where a pre-insolvency communication is filed; and • sanctioning of the plan and resolving any challenges the plan may face	✓ Restructuring expert appointed (at the request of the debtor, creditors representing a majority of the affected debt, or mandatorily by the court in certain case) to issue the relevant certificate attesting the voting majorities of creditors within each class, and across each class, support the creditors and the debtor in negotiating the plan and to issue any reports required by law (such as the debtor´s valuation, if it would be needed) or any other reports the court may request
Sweden *Company Restructuring Process (Företagsrekonstruktion)*	Initiated by the debtor or creditor regarding debtor facing financial distress (e.g. the debtor lacks or will within a short time lack immediately available cash and is as a consequence facing a risk of insolvency)	COMI in Sweden	✓ Automatic stay on all insolvency petitions and enforcement action (subject to very limited exceptions); and prevention of automatic termination of executory contracts and debt acceleration	✓ The court is involved in: • opening the restructuring process and, if requested, a separate restructuring plan negotiation process; and • confirmation of a restructuring plan that has been approved by sufficient majorities	✓ Administrator appointed to advise and supervise the debtor

[38] The pre-insolvency communication or notice refers to a notification made by the debtor to the competent court, informing the court about the commencement of negotiations with its creditors to reach a plan.

Table 10: Voting and Implementation considerations

Jurisdiction	Class formation	Exclusion of creditors	Absolute priority rule (APR)	Release of third-party claims (e.g. guarantor liabilities)	Foreign recognition
Denmark *In Court Restructuring (Indenretlig rekonstruktion)*	• Creditors within a class must have broadly similar interests (e.g. claims with the same insolvency ranking); and • Secured claims have voting rights and must form a separate class	✓ • Claims arising from restructuring proceedings, employee claims, and claims arising from duties, cannot be affected by an agreement between a debtor and its creditors; • Mortgage to the extent covered by the mortgage cannot be affected; and • Creditors with small claims can be excluded under certain circumstances	✓ • All creditors in the same class must be treated equally, unless they consent to less favourable treatment • A class of creditors may not receive less under the plan than what they are entitled to, in comparison with other classes, on the basis of their respective ranking	✗	Recognition within the EU under the Recast EU Insolvency Regulation and the Nordic Insolvency Treaty, rendering coordination possible
Preventive restructuring process (forebyggende rekonstruktion)	Follows the same rules as a regular restructuring process as listed above	Follows the same rules as a regular restructuring process as listed above	Follows the same rules as a regular restructuring process as listed above	✗	Follows the same rules as a regular restructuring process as listed above
England and Wales *Restructuring Plan*	Creditors within a class must have broadly similar 'rights in' (existing rights) and 'rights out' (as amended under the plan) such that they are not so dissimilar as to make it impossible for them to consult together with a view to their common interest	✓ • A class of creditors with no genuine economic interest in the company (i.e., out-of-the money creditors) based on valuation can be excluded from voting upon application to the court; and • The debtor may exclude certain creditors from the plan if commercially justifiable to do so (e.g. trade creditors that are essential to the continuing business)	✗ The fairness of the plan is assessed by reference to the allocation of restructuring value among creditor classes, but there is no formal absolute or modified priority rule	✓ Third-party claims can be released without the need for separate plan for the relevant guarantor	Dependent on a jurisdiction-by-jurisdiction analysis; no automatic EU recognition post-Brexit

Jurisdiction	Class formation	Exclusion of creditors	Absolute priority rule (APR)	Release of third-party claims (e.g. guarantor liabilities)	Foreign recognition
France *Accelerated Safeguard Proceedings (Sauvegarde Accélérée)*	Creditors within a class must share a sufficient commonality of economic interest, subject to the below principles: • Secured creditors must be placed in a different class to unsecured creditors; • subordination arrangements must be complied with; and • equity holders make up one or more classes (if affected)	✓ • Certain type of creditors (e.g. suppliers) may be excluded and will therefore not be affected by the proceedings (no automatic stay etc. is possible); or • The debtor is able to reach separate agreements with creditors whose debts do not need to be compromised under the plan	✓ Creditors of a class that voted against the safeguard plan must be fully repaid (by identical or equivalent means) when a lower-ranking class is entitled to be paid or retains an interest[39]	✗ Third-party claims require a separate plan at the level of the relevant guarantor	Automatic recognition within the EU under the Recast EU Insolvency Regulation; and jurisdiction-by-jurisdiction analysis outside the EU
Germany *Preventive Restructuring Process (StaRUG)*	• Secured creditors, common creditors, subordinated creditors and shareholders must be placed into separate classes; and • within the above mandatory classes, optional groups can be formed for certain creditors who have the same economic rights and if the so-formed groups are separated appropriately	✓ • Claims by employees, and claims arising from torts and fines cannot be affected by a plan; • Other creditors may be excluded where justified (e.g. because they are envisaged to be repaid in full); or • Creditors with small claims (determined on a case by case basis) can be excluded if the restructuring only affects the debtor's financing agreements and the corresponding collateral	✓ However, statutes provide certain exemptions for the APR (e.g. if a maturity extension of less than 18 months is implemented through the plan)	✓ Third-party claims can be released without the need for separate plan for the relevant guarantor (provided it is within the debtor's group)	• Automatic recognition of a public proceeding within the EU under the Recast EU Insolvency Regulation; and jurisdiction-by-jurisdiction analysis outside the EU; and • Recognition of private proceedings still disputed among scholars and subject to a jurisdiction-by-jurisdiction analysis
Italy *Composition with creditors (concordato preventivo) – CWC*	Creditors with the same legal rights (secured or unsecured) and economic interests against the debtor (e.g. financial creditors, suppliers and public creditors) are included in the same class	✓ • Creditors with no genuine economic interest in the plan because they are envisaged to be repaid in full; and • Creditors with conflicting interests (e.g. related parties)	✓ Applies together with relative priority rule in specific cases	✗	Automatic recognition within the EU under the Recast EU Insolvency Regulation; and jurisdiction-by-jurisdiction analysis outside the EU

[39] The court may, however, make exceptions to this requirement (e.g. in the case of strategic suppliers, tort claims, or even shareholders) if it is deemed necessary to achieve the plan's objectives and is not excessively prejudicial to the rights or interests of impaired parties.

Jurisdiction	Class formation	Exclusion of creditors	Absolute priority rule (APR)	Release of third-party claims (e.g. guarantor liabilities)	Foreign recognition
Luxembourg *Judicial Reorganisation (Réorganisation Judiciaire)*	Creditors can be divided into: • a class of extraordinary creditors comprising holders of: (i) claims secured by a special lien or mortgage; (ii) claims by owner-creditors; and (iii) claims by tax and social security authorities; and • a class of ordinary creditors (all creditors other than extraordinary creditors)	✗	✗	✗	Automatic recognition within the EU under the Recast EU Insolvency Regulation; and jurisdiction-by-jurisdiction analysis outside the EU
Netherlands *Dutch Scheme (Wet homologatie onderhands akkoord) – WHOA*	Creditors and shareholders whose positions deviate in such way that they are no longer in a similar position, including based on: • 'rights in' and 'rights out'; and • ranking (i.e., different ranking, whether by law or contractually, means different class)	✓ A class of creditors can be excluded from the plan if sufficiently justified, in particular, in view of the APR	✓ Meaning that a class of creditors or shareholders may not receive less under the plan than they are entitled to in comparison with other classes on the basis of their respective ranking, unless a deviation is reasonably justified and the interests of dissenting creditors / shareholders are not affected	✓ Guarantor liabilities can be included in the plan without need for separate plan for the relevant guarantor	• For public proceedings based on COMI: automatic EU recognition under the Recast EU Insolvency Regulation; and jurisdiction-by-jurisdiction analysis outside the EU • For private proceedings based on sufficient connection: dependent on a jurisdiction-by-jurisdiction analysis
Norway *Company Restructuring process (Rekonstruksjon)*	• One class of creditors (unsecured creditors) • Equal treatment within classes	✓ Creditors with small claims can be excluded under certain circumstances	✗	✗	Dependent on a jurisdiction-by-jurisdiction analysis; no automatic EU recognition.
Spain *Restructuring Plan (Planes De Reestructuración)*	• Creditors in the same class must have a common interest (e.g. claims with the same insolvency ranking); • Creditors whose claims would rank equally in an insolvency proceeding may be separated if there are sufficient reasons to justify such separation; or • Secured claims and public claims are grouped into separate classes	✓ With relevant justification, but labour and other limited categories of claims cannot be compromised	✓ Exceptionally, a plan that breaches the APR may be sanctioned if the breach is key to ensuring the debtor's viability and affected creditors are not unjustifiably prejudiced	✓ A guarantor need not be part of the plan if the enforcement of the guarantee may trigger the insolvency of both the debtor and the guarantor	Automatic recognition within the EU under the Recast EU Insolvency Regulation and jurisdiction-by-jurisdiction analysis outside the EU

Jurisdiction	Class formation	Exclusion of creditors	Absolute priority rule (APR)	Release of third-party claims (e.g. guarantor liabilities)	Foreign recognition
Sweden *Company Restructuring Process (Företagsrekonstruktion)*	Affected parties are divided into one or more of the following groups: 1. creditors whose claims are associated with a right of property, a security interest, or a right of set-off; 2. creditors with claims under public law, where the claim is not a claim as referred to in (1) or (3); 3. creditors with subordinated claims; 4. creditors with claims other than those referred to in (1)-(3); and 5. shareholders or other parties who have an ownership interest in the debtor or in the debtor's business Affected parties in groups (1)-(5) may in turn be divided into additional groups if justified by their similar interests	✓ • A class of unaffected creditors or shareholders can be excluded from the restructuring measures in the plan, provided this is justified; and • Small claims can also be excluded if justified	✓ The class or classes of affected parties that voted against the plan must receive full satisfaction of their claims, provided that a class which has lower priority in the event of the debtor's bankruptcy receives a payment or retains rights under the plan Deviation from the APR are permitted in exceptional circumstances	×	Automatic recognition within the EU under the Recast EU Insolvency Regulation; and jurisdiction-by-jurisdiction analysis outside the EU

Glossary[40]

Absolute priority rule / APR

A concept derived from restructurings effected under Chapter 11 of the U.S. Bankruptcy Code which prescribes that, by reference to the priority of creditors' claims against a debtor that is reorganised or liquidated under a reorganisation plan, classes ranking more senior must receive full distributions on account of their claims before classes ranking more junior may receive any distributions, unless the senior classes consent by acceptance of the reorganisation plan. The Restructuring Directive includes the concept by stating that dissenting class of affected creditors may be protected by ensuring that such dissenting class is paid in full if a more junior class receives any distribution or keeps any interest under the restructuring plan.

Best interest of creditors test

A concept included in the Restructuring Directive under which no dissenting creditor should be worse off under a restructuring plan that it would be (a) either in the case of a liquidation (which includes a piecemeal break-up or sale of the business of a going concern); or (b) in the event of the next best alternative scenario if the restructuring plan were not to be confirmed. In implementing the Directive, each EU member state was given the freedom to determine the appropriate comparator for its individual restructuring process.

COMI

A debtor's "centre of main interests", which is defined under Article 3(1) of the Recast EU Insolvency Regulation as the place where the debtor conducts the administration of its interests on a regular basis and which is ascertainable by third parties. The determination of where a company has its COMI is, ultimately, a question of fact.

[40] For more guidance on jargon and terminology used in restructuring and special situations matters, please see The Book of Jargon® – Restructuring & Special Situations available at https://www.lw.com/en/book-of-jargon/boj-restructuring-special-situations

Cross-class cramdown

The scenario in which a restructuring proposal has not been approved by each affected class of creditors and/or shareholders in accordance with the specified statutory majorities, but the court which has jurisdiction over the proceedings nevertheless exercises a statutory discretion to approve the restructuring proposal such that all creditor and shareholder classes affected by the restructuring proposal (including any dissenting class that did not vote in favour) are bound.

DIP financing

Shorthand for "Debtor in Possession financing" which is a concept derived from restructurings effected under Chapter 11 of the U.S. Bankruptcy Code to refer to financing arranged for a debtor for the period during which it is in the Chapter 11 process. The principal, interest and fees under a DIP financing facility typically rank as super-priority claims ahead of any other indebtedness of the debtor and are secured on a senior-ranking basis over the debtor's assets.

Drop-downs

Liability management transactions where a borrower moves assets outside the restricted group, using them as collateral for new borrowing that is structurally senior to the original financing. Recently, drop-down transactions have evolved to enhance credit support for new lenders. This is achieved by offering a receivables pledge over an intercompany loan from the unrestricted subsidiary borrower to the existing credit group (funded using the proceeds of the new structurally senior financing). Additionally, guarantees of the new debt may be provided by the existing credit group or by entities outside the existing credit group – these transactions are commonly known as "double dip" transactions.

English restructuring plan

A statutory procedure provided for under Part 26 of the UK Companies Act 2006 allowing a company which has encountered, or is likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern; to enter into a compromise or arrangement with its creditors, its members or, in either case, any class of them to eliminate, reduce or prevent, or mitigate the effect of, any of the company's financial difficulties. Creditors or members are divided into different classes to vote on the scheme, taking into account their rights before and after the proposes scheme. In order for the Court to sanction the scheme, those present and voting and representing 75% of value of those present and voting in each class most approve the scheme. However, the Court retains discretion to sanction a restructuring plan on the basis of a Cross-class cramdown, where the following two conditions are met: (a) none of the dissenting creditors would be any worse off than they would be in the RP's 'relevant alternative' (being whatever the Court considers would be most likely to occur in relation to the company if the restructuring plan is not sanctioned); and (b) the requisite 75% in value majority must have been obtained in respect of at least one class of creditors who would receive a payment, or have a genuine economic interest in the company, in the relevant alternative.

English scheme of arrangement

A statutory procedure provided for under Part 26 of the UK Companies Act 2006 allowing a company to enter into a compromise or arrangement with its creditors, its members or, in either case, any class of them. Creditors or members are divided into different classes to vote on the scheme, taking into account their rights before and after the proposes scheme. In order for the Court to sanction the scheme, a majority in number of those present and voting and representing 75% of value of those present and voting in each class most approve the scheme. A scheme will therefore bind non-consenting or dissenting minority creditors within consenting classes, provided that all classes have voted in favour.

In-the-money

The principle that a creditor will have an economic interest in the post-restructured capital of a debtor on the basis that, if instead of the proposed restructuring the debtor entered into a formal insolvency process, the creditor would receive a distribution from the assets of the debtor in respect of its claims.

Liquidation value

The estimated recoveries for a debtor's creditors, upon realisation of the debtor's assets, in a formal insolvent liquidation process.

Moratorium / Stay

A period of time imposed by statue or by order of the court during which creditors cannot enforce their rights under their financing arrangements against the debtor, in order to allow the debtor breathing space to negotiate a compromise.

No creditor worse off

The principle that a creditor should not be left in a worse position as a result of the restructuring being effected than it would have been had the debtor instead entered into a formal insolvency process.

Out-of-the money

The principle that a creditor will not have an economic interest in the post-restructured capital of a debtor on the basis that, if instead of the proposed restructuring, the debtor entered into a formal insolvency process, the creditor would not make any recovery in respect of its claims.

Recast EU Insolvency Regulation

Regulation (EU) 2015 / 848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast).

Relative priority rule

This concept allows for deviations from the absolute priority rule. For instance, it may be deemed fair for equity holders to retain certain interests under the plan, even if a more senior class must accept a reduction in its claims, or for essential suppliers, protected by the stay of individual enforcement actions, to be paid before more senior creditor classes. This derogation from the absolute priority rule may facilitate implementation of a restructuring plan in a way that supports the debtor's ongoing business operations whilst balancing the interests of all creditors.

Restructuring Directive

Directive (EU) 2019 / 1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt.

Uptier

Liability management transactions involving a borrower incurring new priority debt or improving the prior of an existing tranche of debt. Typically, this involves a subset of existing lenders providing the additional "super priority" financing whilst consenting to the necessary amendments under the existing debt in order to prioritise the new debt. This process may include rolling up existing creditor debt into a facility that is senior to the remaining debt but junior to the new tranche.

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Key cases

CMC Ravenna (2020) Italy

Astaldi (2020) Italy

Virgin Active (2021) [England and Wales]

Smile Telecoms (2021) [England and Wales]

Gate Group (2021) [England and Wales]

Eterna GmbH (2021) [Germany]

Prosafe (2021) [Norway]

Norwegian Air Shuttle (2021) [Norway + Irish examinership processes]

Pierre & Vacances (2022) [France]

Maccaferri (2022) [Italy]

Moby (2022) [Italy]

Gym chain (2022) [Netherlands]

DOF ASA (2022) [Norway]

Celsa (2023) [Spain]

Single Home (2023) [Spain]

Orpéa (2023) [France]

LEONI AG (2023) [Germany]

Softline AG (2023) [Germany]

Gerry Weber (2023) [Germany]

Royal IHC (2023) [Netherlands]

Vroon (2023) [Netherlands + England and Wales]

Steinhoff (2023) [Netherlands]

Diebold (2023) [Netherlands + U.S. Chapter 11]

Cimolai (2023) [Italy]

Naviera Armas (2024) [Spain]

Adler (2024) [England and Wales]

Casino (2024) [France]

Spark Networks SE (2024) [Germany]

McDermott (2024) [England and Wales + Netherlands]

Atos (2024) [France]

SAS (2024) [Sweden + U.S. Chapter 11]

Markbygden [2024] Sweden

Alpha Insurance (ongoing) [Denmark]

VARTA AG (2024) [Germany]

iQera (2025) [France]

Qudos Insurance (ongoing) [Denmark]

Kvalitena (ongoing) Sweden

Thames Water (2025) [England and Wales]

PART 7
Private Credit Investing: Perspectives from an Institutional Investor and Early Mover

Over the past 15 years, well-diversified portfolios of first lien private debt have produced resilient performance through economic cycles, delivering high cash yields in line with expectations coupled with low loss ratios. These attributes have made private debt a core portfolio allocation for insurers.

Private debt combines stable and predictable cash flows with strong downside protection, enabling insurers to build diversified portfolios of loans that capture attractive credit risk and complexity premia, and augment their sovereign and government agency holdings. Although private debt is illiquid, loans terms are typically less than three years. During downturns such as 2022-23, some term extensions have been necessary but overall, these issues have proved manageable. Indeed, the downside protection features embedded in senior secured and first lien private debt, which underpin the asset class's low expected loss rates, also make it attractive in terms of regulatory capital weightings.

Seven priorities for private debt portfolio construction

Selecting a private debt manager should be seen as a key element of a broader portfolio construction exercise. The manager selection process must consider each potential candidate's expertise and track record in each sector and jurisdiction so that the investor can benefit from the specialist expertise of each lending partner.

With this in mind, investors should focus on the following criteria in constructing a private debt portfolio.

Concentration by name: Managing idiosyncratic risk is key to effective diversification – the investor's first line of defence. Given that the best outcome an investor can expect from its private debt exposure is payment of the coupon and repayment of the principal, there is little margin for error. A maximum portfolio exposure of 0.1% per name has proved a good discipline historically.

Manager overlap: Ensuring limited overlap between managers is also important to achieve a diversified portfolio in which idiosyncratic risk is well managed.

Geographical diversification: A well-balanced private debt portfolio spanning Europe and the U.S. is optimal from the perspectives of macro risk mitigation and capital deployment. Investors could also consider diversifying further with the right partners in Asia-Pacific.

Borrower characteristics: Given that private debt financing offers no equity upside to investors, the strategy must focus on countercyclical sectors and select borrowers with high organic and/or external growth potential unpinned by high-quality management and a diversified client base. Investors should favour businesses that offer non-discretionary products and services, and have predictable cash flows, high customer retention, good cost control and market agility.

Broad asset class exposure: Comprehensive positioning across sub-segments of the private debt market is important to capture the best financing opportunities through the cycle and to avoid becoming dependent on the dynamics (such as pricing or underwriting criteria) of a single sub-market. Coverage could include lower, core and upper segments of the market including both sponsored and, notably in the U.S., non-sponsored borrowers.

Underwriting discipline: Thoroughly assessing the underwriting discipline and work-out capabilities of each manager is essential to build a resilient private debt portfolio.

ESG: ESG considerations have become central to the private debt managers. Investors should ensure that their managers:

- Have fully integrated ESG analysis in the governance of their underwriting and investment decision-making
- Provide regular reporting on ESG-linked KPIs
- Monitor the progress of their borrowers against a set of ESG objectives agreed before the financing is granted
- Engage with their portfolio companies' management teams on the key ESG dimensions of the business.

Considerations in how to access the asset class – commingled funds vs SMAs

For big institutional investors, separately managed accounts (SMAs or Fund to One) may be preferred to commingled vehicles as a way to invest in private debt. SMAs enable manager and client to construct a bespoke portfolio that best matches the investor's needs as these evolve, while leaving the manager enough discretion to deploy capital efficiently.

SMAs also enable better risk management practices on the part of investors since they can provide greater transparency and more efficient portfolio monitoring from the investor's perspective.

A broader set of private debt opportunities is emerging

An increasing number of institutional investors with established portfolios of high-yielding first lien private debt are looking to diversifying into "satellite" credit strategies. This could involve moving more towards investment grade and crossover credits, or towards the higher-risk and more idiosyncratic end of the investment spectrum.

Figure 1: Asset allocation as of Q4 2024

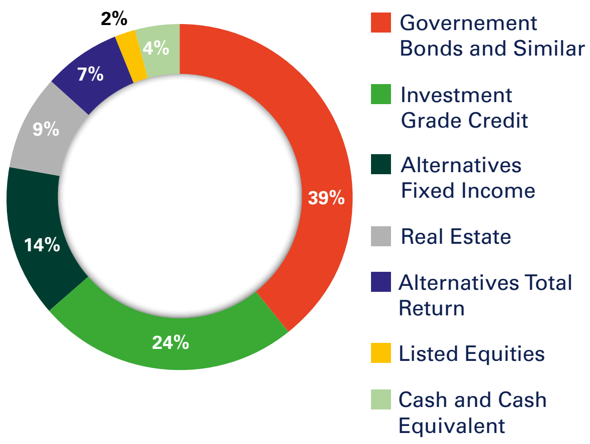
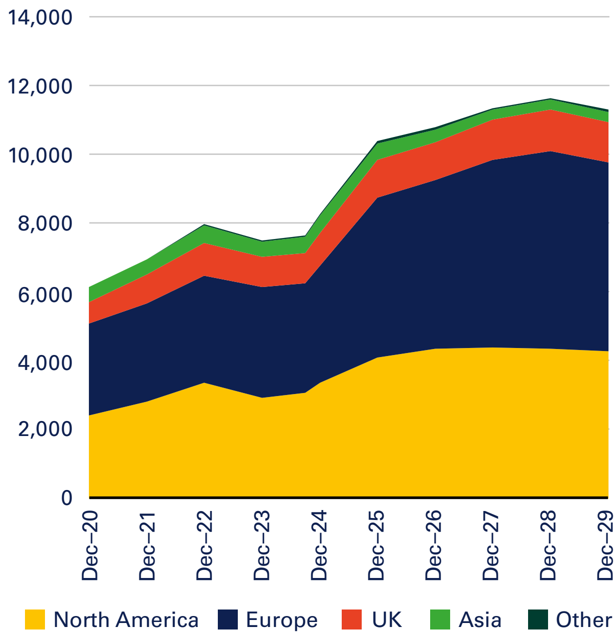


Figure 2: Exposure to direct lending – forecast 2020–2028 (€m)



In the case of investment grade and crossover debt, the long-term increase in public-to-private transactions is providing multiple opportunities. These include:

- Financing of operating assets: this ranges from the well-understood risk profiles of commercial real estate and infrastructure through to far more diversified pools of assts such as consumer finance, energy transition and AI-linked assets
- Carve outs of specific operating units from large investment-grade companies that require significant capex or growth finance
- Net asset value ("NAV Financing") loans to private equity funds, executed through well-structured and covenanted transactions, and addressing a range of requirements such as:
  - Low loan-to-value NAV financing for individual primary LBO funds
  - Higher loan-to-value financing for diversified private equity primary funds of funds
  - Higher loan-to-value financing for diversified private equity secondary funds
  - Dual recourse NAV financing of unfunded LPs commitments to concentrated private equity vehicles containing one or two assets.

Widening access to public or private ratings assigned by well-established rating agencies will be necessary to encourage more institutional investors to increase their exposure to investment grade private credit.

At the higher-risk end of the spectrum, Opportunistic Credit is one of the most widely followed strategies among investors. Opportunistic Credit offers:

- Diversified idiosyncratic risk through the financing of more complex businesses / situations, for which plain vanilla first lien debt is not suitable
- An appealing risk premium over unitranche portfolios. This may include an equity and/or a junior debt component to remunerate increased risk and complexity

- A way to participate in both an increase in the number of stressed idiosyncratic financing opportunities and more widespread dislocation of the credit market.

The Opportunistic Credit market comprises a diverse set of players. Investors therefore require a deep understanding of this segment to identify the areas that both match their risk appetite and yield objectives, and complement their existing private debt portfolio.

Retail participation in private debt is growing

On the back of both accelerated bank disintermediation over the past 15 years as well as the growth of the public-to-private dynamic, retail wealth managers are increasingly keen to add private assets, including private debt, to their offering. Private debt has features that are attractive for retail / wealth management clients, notably:

- Relatively appealing all-in yields
- An embedded liquidity profile superior to real estate and private equity, based on short durations and regular cash interest payments
- Relatively stable valuations, driven by the senior profile of the lending and the defensive qualities of the underlying businesses

The U.S. paved the way for retail access to private debt decades ago by launching SEC-regulated, listed Business Development Companies to give retail investors access to portfolios of high-yield corporate loans. Since 2022, retail private debt products have multiplied in Europe to complement existing offerings by wealth management networks and the unit-linked products offered by insurers. The introduction in 2024 of the ELTIF 2.0 framework for retail-focused semi-liquid private markets funds has provided further support for this trend.

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PART 8
European Senior Debt Index

LINCOLN INTERNATIONAL

The European non-investment grade corporate loan market has two segments: the public BSL market, which attracts investors investing in broadly syndicated loan deals, and the private direct lending market for investors investing in club deals. While correlated, there are subtle but significant differences between the two markets as outlined in the main body of this report.

In contrast to the Morningstar European Leveraged Loan Index ("ELLI") which is comprised of companies borrowing in the BSL market, the constituents in Lincoln's European Senior Debt Index ("ESDI") are all European private credit borrowers that Lincoln provides recurring valuations for, and that are valued on a "bottom-up" basis from fundamental financial information that Lincoln is provided.

The European direct lending market is a significant and rapidly growing source of capital to private equity-backed middle-market companies. The Lincoln European Senior Debt Index benefits market participants by providing information to facilitate a greater understanding of the attributes of this important source of capital to the private sector.

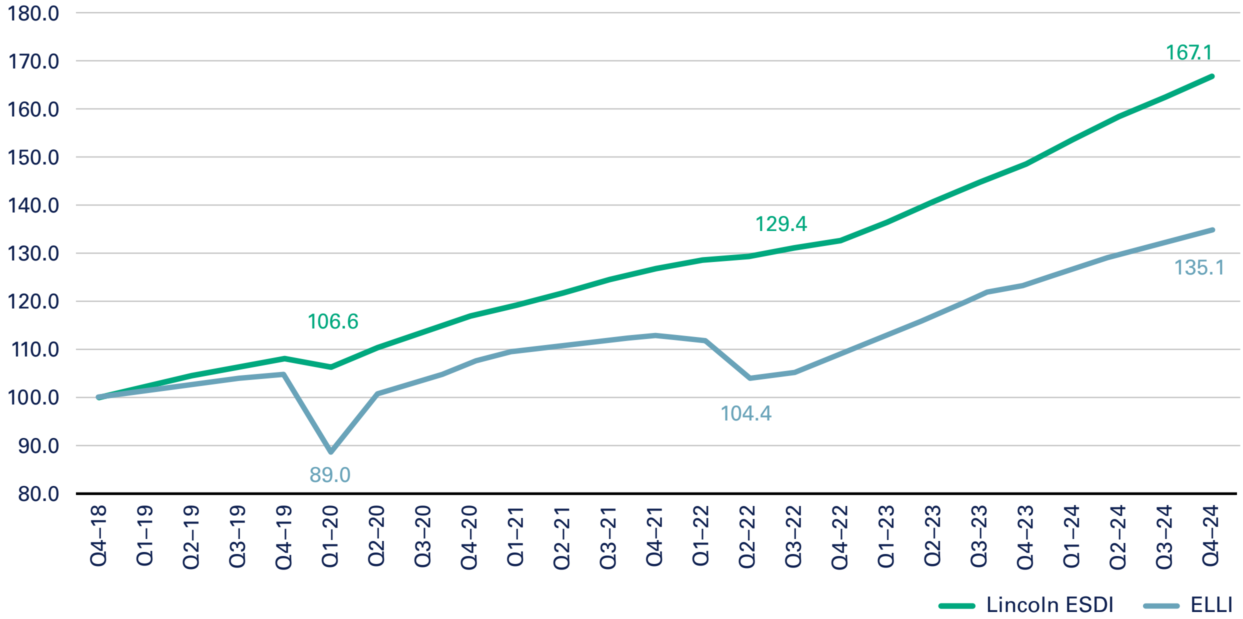
For companies in the ESDI, Lincoln advises on the quarterly fair values of at least one senior debt security in the capital structure, and must be valued on a recurring basis, to provide comparability to prior periods. All valuations conform with IFRS and/ or U.S. GAAP and fair value principles and have been typically reviewed by fund management, fund boards, limited partners, and/ or auditors in addition to Lincoln. Additionally, Lincoln works with market-leading academics at the University of Chicago Booth in order to assemble and peer review our index results.

European private credit cumulative performance relative to European public credit markets

Since the inception of the ESDI in Q4 2018, it has outperformed the ELLI when comparing total return (Figure 1). The total return is calculated as the cumulative value of the index adjusted for total quarterly returns each quarter. As of Q4 2024, the index value for the ESDI was at 167.1, relative to 135.1 for the ELLI. The CAGR, since inception, for the ESDI was 8.9% in comparison to the 5.1% experienced in the ELLI. The standard deviation of annual returns was also lower within the ESDI, at 2.8% as opposed to 8.3% within the BSL. It can therefore be concluded that both total returns are consistently higher, and the volatility of returns is lower.

In addition, the direct lending market experiences negative returns much less frequently than the BSL market (Figure 4). Since the inception of the European Senior Debt Index on December 31, 2018, through December 31, 2024, the ESDI reported a negative quarterly return only in Q1 2020 whereas the BSL market has experienced 3 quarters of negative returns. There are several reasons for the phenomenon whereby loans in the direct lending market do not experience the same volatility as observed in the BSL market. For instance, loans within the direct lending market trade much less frequently than loans in the BSL market. Investors in the BSL market are subject to capital flows and therefore potential liquidity constraints, leading to much higher volatility in public marks and implied yields.

Figure 1: Comparison of total return – Lincoln ESDI to Morningstar ELLI



The starting date of the Lincoln ESDI is Q4 2018 commencing with an index value of 100.0.

	Average Quarterly Returns (since Q1 2019)	2024 Annual Returns	CAGR (since Q1 2019)	Standard Deviation of Annual Returns (since Q1 2019)
Lincoln ESDI	**2.2%**	**12.4%**	**8.9%**	**2.8%**
ELLI	**1.4%**	**9.1%**	**5.1%**	**8.3%**

European private credit annual returns relative to European public credit markets

When comparing the annual return of the ESDI to the ELLI for each year since inception, the returns for the ESDI have exceeded that of the ELLI, except for 2023 (Figure 2). In 2022, the public credit index saw a decrease in index value from the end of 2021 of 3.5%, as a consequence of inflationary pressures on public market sentiment at the time. A greater rebound was experienced in the public credit market within 2023.

The year for the second lowest annual return for the ELLI was in 2020 as the public markets were reacting to the impact of the COVID-19 pandemic. What is interesting is that the private credit market remained stable from the previous year.

Figure 2: Comparison of annual returns – Lincoln ESDI to Morningstar ELLI

	2019 Annual Returns	2020 Annual Returns	2021 Annual Returns	2022 Annual Returns	2023 Annual Returns	2024 Annual Returns
Lincoln ESDI	**8.1%**	**8.2%**	**8.5%**	**4.6%**	**12.0%**	**12.4%**
ELLI	**4.9%**	**2.4%**	**5.2%**	**(3.5%)**	**13.6%**	**9.1%**

Focusing on yields for each respective index, for each period since the inception of the ESDI in December 31, 2018, annual yields within the ESDI have exceeded that of the public market (Figure 3). For the quarter ending December 31, 2024, the yield of the Lincoln European Senior Debt Index (ESDI) was 9.9%, exceeding its 5-year historical average of 9.4%, while the yield of the European Leveraged Loan Index (ELLI) was 7.3%, above its historical average of 6.2%, both driven by elevated base rates relative to earlier periods. Though the difference in the yield relative to the average has recently narrowed in 2024 as base rates began to decline.

Within 2024 the gap in yields between the European private and public credit markets were below the historical average, with the gap as of December 31, 2024, being 2.6%, against the 3.2% historical average difference. This can be attributed to greater competition to deploy capital in private credit and therefore reducing the return differential between the two markets.

Figure 3: Comparison of yields – Lincoln European Senior Debt Index to Broadly Syndicated Loan Market (ELLI)

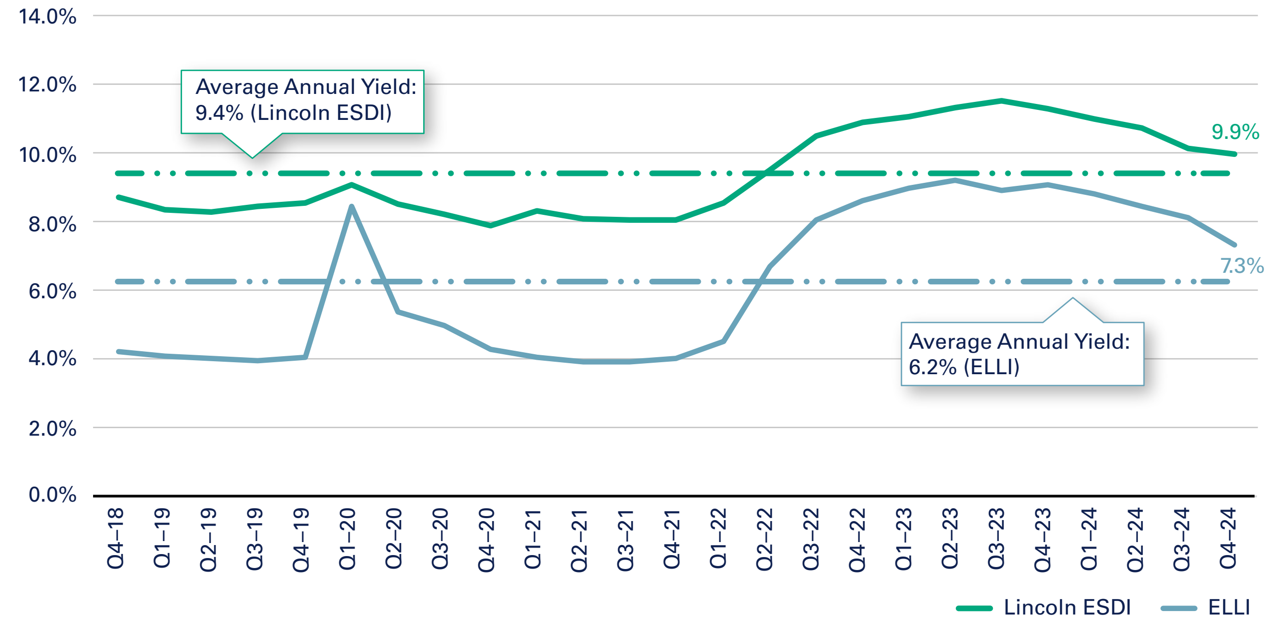
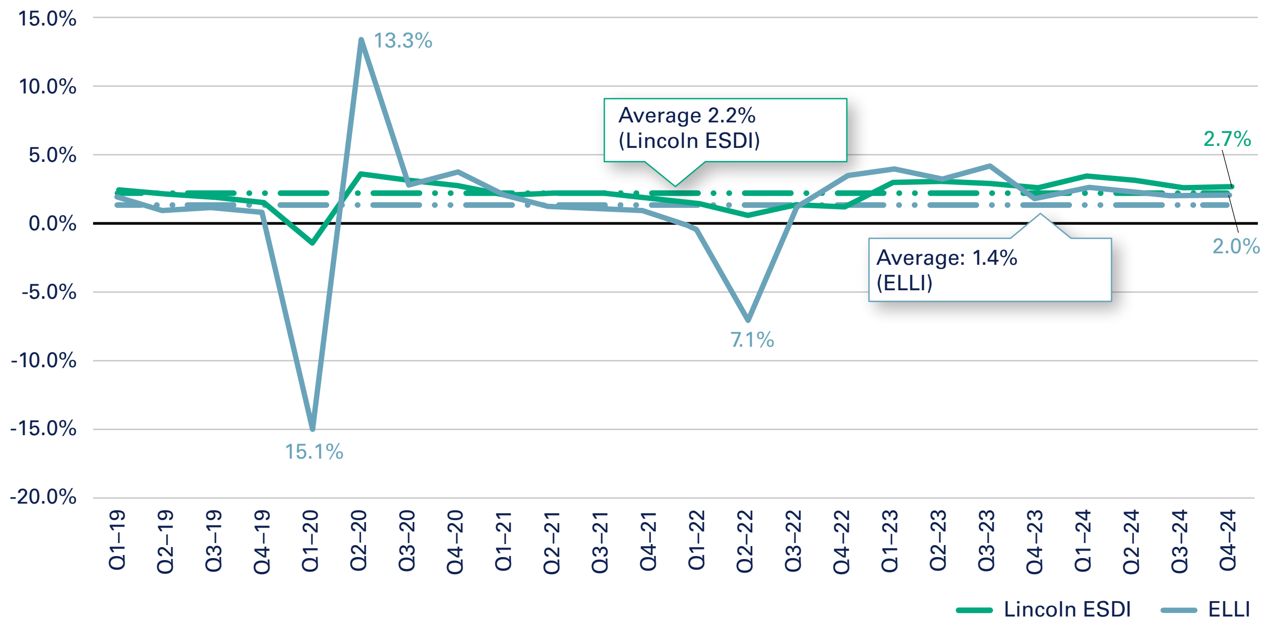


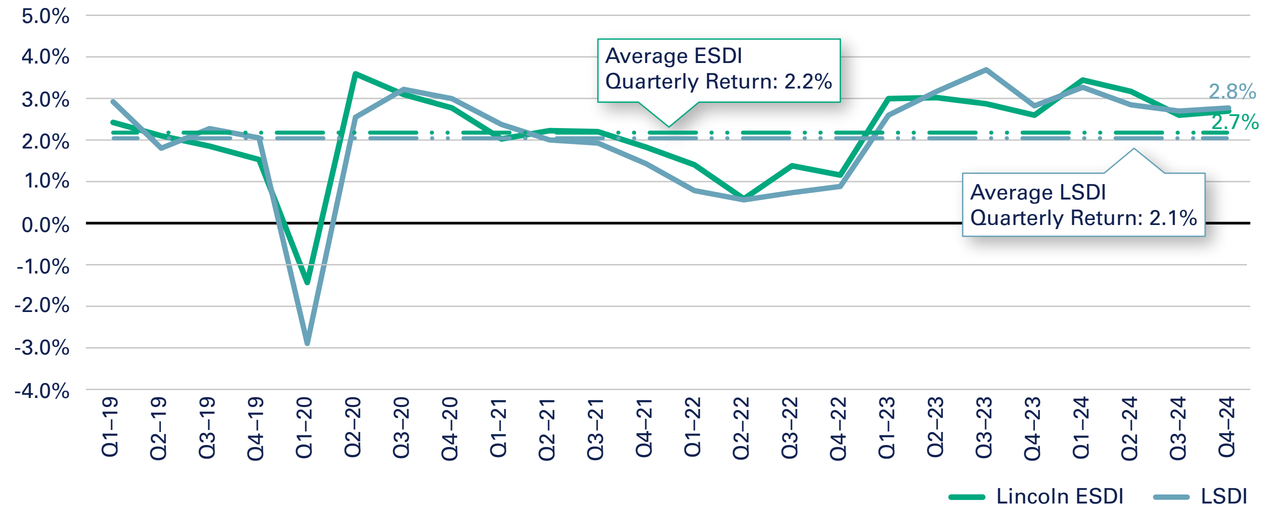
Figure 4: Correlation and comparison of quarterly returns – Lincoln European Senior Debt Index to Broadly Syndicated Loan Market (ELLI)



European vs U.S. private credit returns

Quarterly private credit returns on average over the past 5 years have been slightly more attractive in Europe than U.S. with a lower volatility (Figure 5). The Lincoln Senior Debt Index™ ("Lincoln SDI") works in much the same way as the ESDI, but for loans originated within the United States. Returns in 2024 were at 12.1%, which were lower than that of Europe, as previously mentioned, at 12.4%.[41] The relative CAGR of the two indices, since Q1 2019, were 8.9% against 8.5%, in favour of the European market. Additionally, standard deviation of annual returns was lower for the ESDI at 2.8% versus 3.6% for the U.S. private credit market.

Figure 5: Comparison of quarterly returns – Lincoln European Senior Debt Index to Lincoln Senior Debt Index (U.S.)[41]



Index Yields

Figure 6: Comparison of yields – Lincoln European Senior Debt Index to Lincoln Senior Debt Index (U.S.)

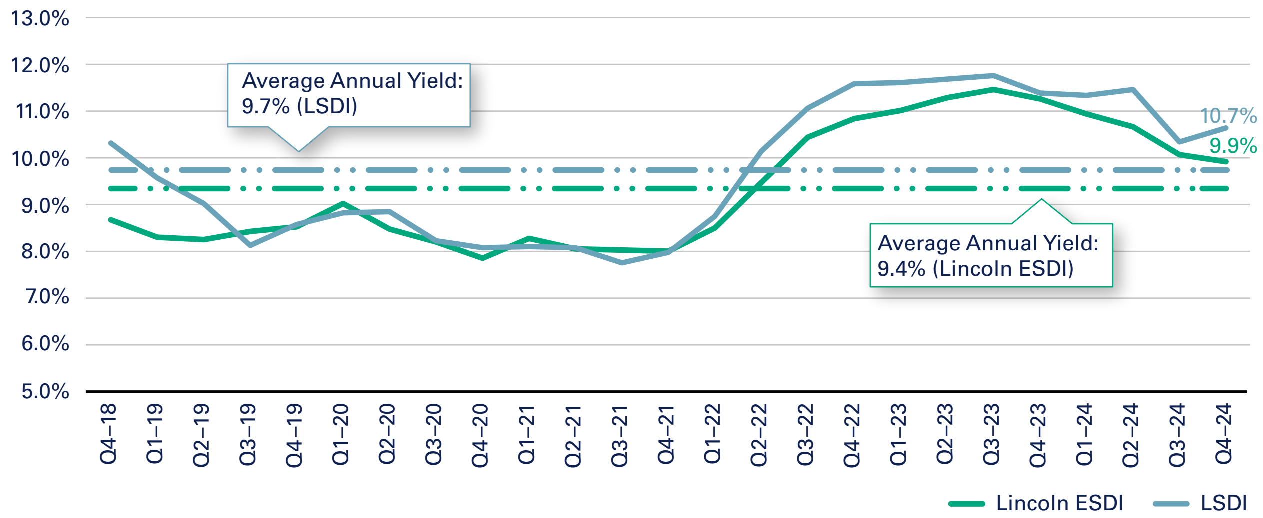


Figure 6 highlights that annual returns in the LSDI were higher, at a historical average of 9.7% relative to 9.4% observed in the European index. This is on account of higher base rates within the U.S. market.

The indices are highly correlated with a correlation factor of 95%, although it can be observed the impact of COVID-19, higher inflation, and interest rates had a greater impact on returns within the U.S. direct lending market, thus in part, explaining the greater volatility experienced.

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41 Exchange rate movements between USD and EUR do not impact quarterly returns as they are based on underlying contractual coupon rates and capital gains for each constituent.

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About Saïd Business School, University of Oxford

The University of Oxford – Saïd Business School consistently ranks among the world's top business schools for research quality and business education. The school embodies the academic rigour and forward thinking that has made Oxford University a world leader in research and education for over 900 years. The school is renowned for its research and teaching on private assets.

About Pemberton Asset Management

Pemberton Asset Management is a leading European private credit manager. Built on more than a decade of experience and industry-leading credit expertise, we provide innovative, cycle-tested private credit solutions for LPs and GPs. Pemberton's extensive origination network of ten European offices, local market and sector expertise are core characteristics of Pemberton's value proposition. A substantial investment team, a broad and independent credit function and rigorous credit analysis inform our investment approach. We are committed to advancing responsible investing in private credit and foster long-term value through transparent partnerships.

About Latham & Watkins

Latham & Watkins is a global law firm with more than 3,500 lawyers in its offices located in Asia, Europe, the Middle East and the United States. The firm has internationally recognized practices in a wide spectrum of transactional, litigation, corporate and regulatory areas. Our success is grounded in our devotion to the collaborative process, which reaches across global offices and practices and draws upon our deep subject matter expertise, an abiding commitment to teamwork and a powerful tradition of creative lawyering.

About AXA Group

The AXA Group is a worldwide leader in insurance and asset management, with 154,000 employees serving 95 million clients in 50 countries. In 2024, IFRS17 revenues amounted to Euro 110.3 billion and IFRS17 underlying earnings amounted to Euro 8.1 billion. AXA had Euro 983 billion in assets under management, including assets managed on behalf of third parties, as of December 31, 2024.

The AXA ordinary share is listed on compartment A of Euronext Paris under the ticker symbol CS (ISN FR 0000120628 – Bloomberg: CS FP – Reuters: AXAF.PA). AXA's American Depository Share is also quoted on the OTC QX platform under the ticker symbol AXAHY. The AXA Group is included in the main international SRI indexes, such as Dow Jones Sustainability Index (DJSI) and FTSE4GOOD.

It is a founding member of the UN Environment Programme's Finance Initiative (UNEP FI) Principles for Sustainable Insurance and a signatory of the UN Principles for Responsible Investment.

About Lincoln International

Lincoln International ("Lincoln") is the largest independent provider of European private credit valuations. On a quarterly basis, Lincoln values over 6,000 private companies primarily owned by over 175 alternative investment funds. Most of these companies are levered via borrowings from the direct lending market. Lincoln's European Senior Debt Index was developed from the data gathered from the European segment of these valuations and now spans a period of over five years.

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