EXPERT Q&A

An integrated approach to assessing risks associated with geopolitical upheaval, climate change and artificial intelligence is crucial to future-proofing European private credit investing, says Peter Arnold, head of European private markets at LBP AM



European private credit enters an age of disruption

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Q Europe faces multiple sources of disruption, from geopolitics and climate change to macroeconomic volatility and AI. Which of these structural forces do you believe will have the greatest impact on private credit opportunities over the next decade?

The obvious answer is that they all will. We talk about geopolitics as if it is a thing on its own; we talk about artificial intelligence as if it is a thing on its own; and we talk about macroeconomics in the same way. In fact, they interact a lot with each other.

Climate change deserves particular attention. You only have to look at this summer's headlines, when water levels on the Rhine and the Danube fell to record lows. Those rivers are typically very efficient supply lines, and they had to be replaced by road and rail. What would happen, for example, if you were to run a data centre using water from one of those rivers?

We need to look at these pressures as one interconnected system rather than as siloed issues. Only then can we consider how the businesses that we lend to can navigate or mitigate their impact.

We used to talk about an illiquidity premium for private markets, then a complexity premium. Now we can add a resilience premium, as we all seek to lend to firms that can navigate these pressures.

Q Which sectors or areas of the real economy do you believe will require the most private capital in the years ahead?

Infrastructure is an obvious area of focus for private capital investment. The extent of demand in Europe presents great opportunities for private credit, but it does not come without risks. Climate change certainly impacts real assets, regardless of whether you are lending to a wind farm or a data centre.

Real estate is in a similar position when it comes to climate investing. Buildings in the EU account for roughly 40 percent of total energy consumption and 36 percent of greenhouse gas emissions, according to the European Commission, meaning that there is a huge drive to make these buildings greener. Private debt can facilitate that transformation – the capex required will be considerable, but it would result in more valuable buildings.

Finally, within corporate direct lending, it is important that we find companies that are mission-critical in their sector or within a supply chain. These can be asset-light platforms looking to grow via acquisition, or asset-heavy businesses with capex needs but strong pricing power to withstand the multifaceted pressures on them. In the European mid-market, there are local, national or pan-European companies within all the sectors that fall into those categories. Given the deep pool of family-led businesses across Europe, we can find resilient business models within all sectors.

Q What role can private credit play in supporting Europe's economic transformation?

Private credit has an important role to play in the real economy. Our lending is focused on the lower mid-market, often supporting family-owned businesses going through intergenerational change. We can provide support in a non-sponsored capacity, helping those companies grow, build their resilience and create efficient balance sheets to underpin regional or international expansion. Where PE sponsors are involved, whether minority or majority, we can provide tailored solutions to take companies to their next growth phase.

There are plenty of ways in which private credit can be transformative, and they are not always purely financial. Lots of the vulnerabilities we are talking about come up during environmental, social and governance (ESG) credit scoring discussions. ESG considerations have become more critical for a company's bottom line, and our ability to support businesses through those kinds of issues can be extremely valuable.

Q From a direct lending perspective, how do you identify mid-market businesses that are well positioned to adapt and thrive amid these structural changes?

The key things to look at when assessing borrowers are whether they provide essential products and services, whether they are mission-critical, and whether they can adjust their pricing in response to input costs. We look closely at recurring revenues and the way that businesses are managing the structural risks they face.

Suppliers of technology components and business services companies are often critical to their supply chains and have balance sheets capable of adapting to disruption.

The other well positioned area is non-sponsored lending to the lower mid-market, where lenders can reach sectors or companies that you cannot necessarily reach via large cap or core mid-market lending. That speaks to diversification. In that space, we seek out asset-heavy companies that have long histories of performing in their sectors and deep management experience, and that want to expand via generational change rather than a private equity partnership.

There are some key nuances around our investing strategy, however. In infrastructure, we are careful about which countries we invest in because of electricity price volatility. For data centres, we prefer cloud-based assets over ones that focus on artificial intelligence. In real estate, we look at building propositions where there is the most potential to add value through renovation.

> *"We used to talk about an illiquidity premium... now we can add a resilience premium"*

Q How do you see investors reshaping private credit portfolio allocations to build resilience in the future?

We are late in the credit cycle, in my view, so large cap and core mid-market portfolios are having a tough time. That is partly due to maturity extensions, as the underlying equity holdings are simply not selling.

The lower mid-market tends to react more slowly to structural challenges, therefore we expect future portfolios to include lower mid-market, large cap and core mid-market exposures.

In the lower mid-market, one can expect some alpha from lower leverage, coming from a mix of non-sponsored and minority PE holdings. This makes lending less sensitive to the lack of IPO opportunities and the longer hold periods in private equity. The probability of maturity extensions is lower, granularity provides resilience, and there is strong bilateral involvement for lenders if loans encounter difficulties.

Combining that exposure with large cap and core mid-market is now clearly the best way to build a resilient portfolio, because the three markets react differently throughout economic cycles. Now is the time to invest in the lower mid-market, which taps into a wider range of sectors and has slightly less exposure to AI disruption, though previous times have been better for large cap or core lending. ■