

Press Release

AlbaCore Credit Market Update: ‘European Levered Credit Poised to Outperform’

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London, 27 February 2025 – So far in 2025, markets have largely shrugged off negative headlines, with equities hitting record highs and spreads continuing to tighten. However, early January saw government bond yields spike, DeepSeek’s new AI model triggered a risk asset sell off, and fears of trade wars continue to cause ripples in global markets. Against this backdrop, investors are faced with significant dilemmas.

Despite credit spreads reaching relative tights and a challenging European economic outlook, **we believe European leveraged finance credit remains an attractive opportunity.**

The US equity market has outperformed for the past two years, with back-to-back annual returns in excess of 20% for the first time since the late 1990s. This strong performance, led by the Magnificent 7, has stretched equity valuations with cyclically adjusted price-to-earnings ratios of 35 for the S&P at the end of January¹. **Historically, when long term earnings ratios have been this high, the implied subsequent three-year total returns have only been around 1%².**

In our view, this, combined with a potential sell-off triggered by disruptive competitors like DeepSeek, suggests that equity markets may face significant downside risks. In contrast, **we believe levered credit is well-positioned to outperform**, offering contractual coupon income exceeding equity yields, along with the stronger downside protection.

Beyond the macro headlines: the case for European credit

The economic outlook for Europe is clearly more challenging than in the US. IMF’s mid-January growth forecast projected Eurozone GDP growth at 1.0% for 2025, compared to 2.7% for the US.³ However, it is important to look beyond broad economic indicators, which often mask performance differences between sectors and companies. While some borrowers have been affected by higher interest rates and inflation, others continue to see strong growth.

The risk of tariffs between the US and Europe further increases uncertainty, particularly for sectors like autos, but the spread premium in Europe mitigates some of this risk. The ECB has reacted to slower

¹ Source: Bloomberg as of 31 January 2025.

² Source: Bloomberg and AlbaCore analysis. Based on monthly observations from 31 January 1995 to 31 January 2025. CAPE Ratio is the Cyclically Adjusted Price to Earnings Ratio which is calculated by dividing a company’s stock price by the average of the company’s earnings for the last ten years, adjusted for inflation.

³ Source: International Monetary Fund “World Economic Outlook Update, January 2025”.

growth by cutting interest rates more quickly than the Fed, resulting in an increasing interest rate differential between the Eurozone and the US, which is only set to increase.

While a reduction in base rates leads to a corresponding reduction of coupon income for floating rate loans, these lower rates benefit European borrowers by easing the interest burden, improving corporate fundamentals, and reducing default risk.

Investors in the US, UK or Australia are still able to benefit from higher interest rates in their home market if hedging back to their base currency, enabling them to pick up the interest rate differential while benefiting from the higher spreads and more conservative capital structures in Europe.

M&A activity should spur credit opportunities

As interest rates in Europe fall, we expect a rebound in mergers and acquisition (M&A) activity, which is supported by a more favourable regulatory environment and a desire for pan-European cooperation. **This uptick in M&A will likely provide new issue supply for both public and private credit markets.**

While the strength of the syndicated market has seen some issuers return to public markets, refinancing private loans taken out in 2022, direct lending is set to remain a key source of financing for many upper mid-market and large cap issuers. Top tier sponsors have been increasingly active in the upper mid-market as they focus on smaller borrowers where they can execute buy and build strategies with an aim to generate returns through improving margins and growing EBITDAs. The bulk of these opportunities are coming from issuers in the €40-75 million EBITDA space. **These transactions are well suited to the private credit markets, which have features such as delayed draws or acquisition facilities that make direct lending an attractive option for sponsors.**

The improved M&A outlook is also creating opportunities for junior capital solutions, such as mezzanine debt, holding company loans and preferred equity. These hybrid opportunities combine the downside protection of credit with the potential equity upside through features like warrants.

As activity in the larger cap space has increased, we have seen sponsors increasingly interested in junior debt solutions primarily to support new leveraged buyout (LBO) activity. Junior debt provides crucial financing that can bridge gaps in capital structures allowing sponsors to reduce the amount of senior cash pay debt they require to complete an acquisition. As interest rates have fallen in Europe, the lower proportion of cash paying debt in capital structures has given sponsors greater financial flexibility. These cashflows can be diverted to fund initiatives such as bolt on acquisitions or capex investments which will help drive EBITDA growth. With syndicated loan markets offering competitive pricing for high quality issuers, we are seeing some sponsors opt for a combination of senior public financing at a lower leverage and a private junior instrument.

CLO equity arbitrage looks attractive

We believe that the Structured Credit market, particularly new issue CLO equity tranches, also looks compelling. With spreads tightening across credit markets, the weighted average cost of capital for CLO liabilities has fallen from the low 200 basis points in Q4 2024 to 175-185 basis points in February 2025. This presents an opportunity for CLO managers to lock in this low cost of capital for the life of a CLO, potentially leading to excess spreads greater than 200 basis points. **This would represent the best arbitrage opportunity in the European CLO market since 2018.**

CLO equity represents the first loss tranche in the structure and is sensitive to defaults in the underlying loan portfolio. However, defaults in European high yield bonds are expected to be driven by two borrowers and are priced into the market. If macro-economic conditions worsen, new issue CLO equity is well placed to take advantage of any volatility in the loan market. In the event of a market sell-off, CLOs within the early stages of their reinvestment period can invest in loans trading at attractive discounts to par. **CLOs issued just prior to periods of market dislocation, such as 2020 and 2022 vintages, have historically seen some the highest returns for CLO equity holders⁴.** Credit selection in these environments is key, and managers who can distinguish between what is merely market dislocation versus fundamentally stressed credits may see greater outperformance.

For CLO investors with lower risk appetites, AAA and AA tranches offer the highest relative value outside of CLO equity and make an attractive diversifier for an investment grade bond portfolio. They offer investors a spread pick-up versus similarly rated corporate bonds and, as a floating rate asset class, they serve as an interest rate hedge.

Although the strong structural protections and the premium over corporate credit persist, the recent spread tightening in CLO tranches necessitates a more selective investment approach for sub-investment grade tranches in the current market environment. However, broader market events or uncertainty may create pockets of volatility in the CLO market that nimble investors could exploit. We believe taking a credit-focused, bottom-up approach to analyse the underlying credit quality in a CLO is key to **identifying mispriced opportunities in both the primary and secondary market.**

David Allen is the Managing Partner and Chief Investment Officer at AlbaCore Capital Group.



Mr. Allen has more than 30 years of financial services and investment experience, with a focus on the High Yield and Leveraged Finance Markets.

Prior to founding AlbaCore Capital Group, Mr. Allen managed Canada Pension Plan Investment Board's European Principal Credit Fund and was a member of the Investment Committee. Mr. Allen was also a Partner, Investment Committee member and Senior Portfolio Manager at GoldenTree Asset Management, where he established and ran the firm's

European presence. Mr. Allen spent a decade with Morgan Stanley in New York and Hong Kong, working across M&A and investment banking before specializing as a High Yield media analyst.

Mr. Allen graduated from the University of California, Berkeley, where he earned a Bachelor of Arts in Economics and was an all-conference rower.

About AlbaCore Capital Group

AlbaCore Capital Group is one of Europe's leading alternative credit specialists, investing in private capital solutions, direct lending, opportunistic and dislocated credit, CLOs, and structured products. Founded in 2016, AlbaCore is part of the First Sentier Investors Group. AlbaCore's investment

⁴ Source: AlbaCore Analysis, BofA Global Research, Intex. Assumes an issuance price of 95 whenever unknown. IRR estimates subject to completeness & accuracy of Intex data. Excludes non-standard equity tranches.

philosophy is focused on capital preservation and generating attractive risk adjusted returns through the cycle for its investors. AlbaCore manages US \$9.0 billion in AuM⁵ as of 31 December 2024 on behalf of global pension funds, sovereign wealth funds, endowments, insurance companies, family offices and high net worths around the world.

For more information, visit www.AlbaCoreCapitalGroup.com

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⁵ AuM is calculated as the sum of the Net Asset Value, undrawn capital commitments, available debt finance and assets of all vehicles managed by AlbaCore.