January 2025

Credit Strategy 2025 : « Keep it private ! »

Discover Sienna IM's checklist to effectively manage your investments

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The 2025 outlook for European credit markets is positive. The combination of controlled inflation of around 2%, anaemic growth and slightly positive real rates provides a favourable environment for carry strategies, where low volatility and time value are important allies. After years of negative rates where borrowers were the masters of the game, this new environment should continue to give lenders more bargaining power.

However, on the credit front, 2024 has been marked by a significant increase in corporate insolvencies. The latest quarterly figures published by Eurostat, reported in November 2024, show an increase of 2.7% for the seasonally adjusted bankruptcy declarations in the EU, compared with the second quarter of 2024, thus reaching yet another highest level since 2018. The catch-up effect of the Covid19 period is evident, but it does not explain everything.

While it is the smallest companies that have suffered the most, mid-caps and large companies have also been affected. This is particularly the case in Europe, where some economic models have revealed major flaws, such as German energy policy (dependence on Russian gas, nuclear phase-out, variability in renewable production). Sectors such as the automotive industry (7% of European GDP) have suffered the full force of the consequences, with the additional combination of increased foreign competition and restrictive standards.

However, credit markets are anticipating a normalisation of the situation, with expected default rates falling in 2025 compared to 2024. Thus, the rating agency S&P forecasts a default rate of 4.25% in September 2025 (base case) compared to 5.03% in September 2024, for European companies in the speculative category for the rolling 12 months.

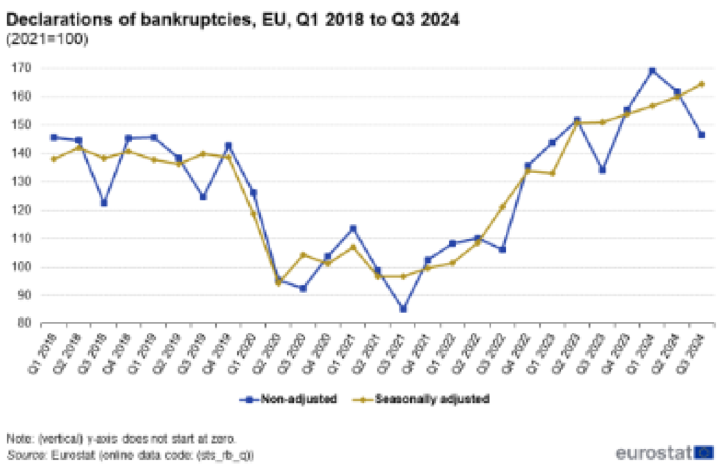
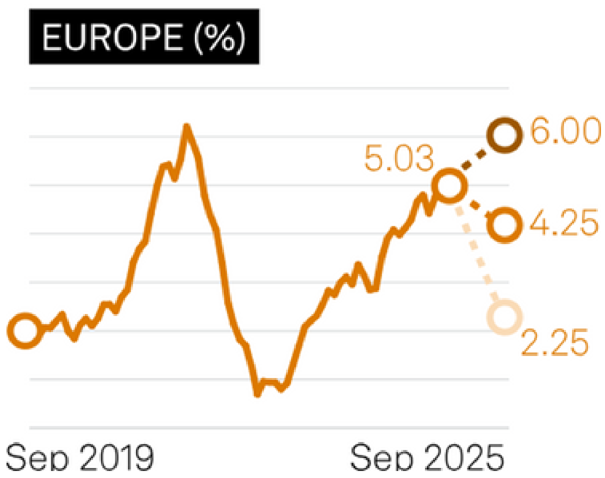


Figure 2: Declarations of bankruptcies, EU (available countries), Q1 2018 to Q3 2024 (2021=100)
Source: Eurostat (sts_rb_q)

Forecast 12-month rolling default rate speculative companies



Source : S&P

Correlatively, the average credit spreads of companies in the speculative category (rated BB+ and below) are 3.10%, compared to 4.00% at the beginning of the year, very close to their lowest level in the last 5 years.

ICE BofA Euro High Yield Option Adjusted Spread

Source: ICE BofA

These positive expectations for credit are driven by slightly improved growth prospects as well as by the assumed existence of a strong debt refinancing capacity. In fact, banks' credit conditions are improving with a decrease in margins and lending rates granted to companies. In addition, the distribution of leveraged acquisition finance debt to investors is operating at full capacity and offers an efficient distribution channel (CLOs).

In this context of still deteriorating data but very positive expectations for credit, what strategy should be favoured for 2025?

Here are our 4 tips for managing your investments effectively :

1. Prioritizing private debt over listed bond debt

Valuations on bond debt listed as high-yield or leveraged loans are close to their historical limit while the economic and geopolitical environment remains very uncertain. In particular, they have benefited from the post-US election euphoria effect, which is expected to start fading out. As such, we anticipate that better entry points will emerge in the coming quarters. As a result, there are two main reasons why we favour private debt:

- Due to its lower responsiveness to exogenous market factors, the downward adjustment of credit spreads has still spread only slightly in the private debt universe.
- Due to the deployment period of private debt funds (around 24 months), they make it possible to invest through the cycle and to be less dependent on immediate market conditions.

2. Positioning oneself on themes driven by a strong economic and political rationality

Since the Covid19 health crisis and the conflict on Europe's doorstep, sovereignty has once again become a central theme. Indeed, controlling production chains and energy costs is now vital for companies. In this context, two financing themes seem particularly interesting to us:

- production tools oriented towards strategic industries for the sovereignty of States, such as the European defence sector. The European Commission estimates that an additional €500 billion will need to be invested in European defence over the next decade. Public calls for action – including the 2024 Draghi Report on European Competitiveness – underline both the scale of this challenge and the strategic opportunity it represents. In this context, mid-sized subcontractors have substantial financing needs during the early stages of contracts, which involve high development costs and little compensatory revenue. The "J" curve of vendor net cash flow throughout the contract lifecycle illustrates this critical need for early financing.

- renewable energy projects and, in particular, alternative sources allowing the smoothing of peaks and troughs in production. These projects are driven not only by the political will to fight against global warming but also by the will to strengthen energy security. Thus, the share of renewable energy in the European energy mix must double by 2030 to reach 42.5%. Conventional sources such as wind and solar power will continue to play a major role, but the variability of their production will require the support of new complementary sources, such as biomethane or hydrogen. Battery storage is also a critical topic in this energy transition. In this sector, financing needs will therefore continue to be significant, and the complexity of financing new complementary energy sources should allow specialized lenders to extract an attractive return.

3. Avoid overly speculative sectors

In the eyes of Sienna IM as a lender, two sectors seem to require increased caution due to their deteriorating fundamentals and lack of visibility. These are the automotive industry, and more specifically automotive subcontractors, and commercial office real estate.

The European **automotive sector** faces many challenges and uncertainties.

- The 2035 target, stipulating that all cars sold in the European Union must be zero-emission, is for the moment maintained but uncertainty about its implementation is increasing;
- Weak demand with declining registration figures (1.7 million new passenger car registrations in France in 2024, a decrease of 3.2% compared to 2023);
- Rising costs and investment needs in new technologies and electric vehicles;
- Competition from foreign vehicles, especially Chinese vehicles.

In this context, car manufacturers have announced restructuring plans, with production and workforce reductions (Bosch, Valeo, ZF, Michelin, VW, etc.). Automotive subcontractors will therefore continue to be impacted, and company insolvencies in the sector are expected to remain at a high level in 2025.

The financing of office **real estate** is still subject to excessive imbalances. Faced with the inability to find leaseholders for many buildings put on the market, sponsors have renegotiated existing debts with extended maturities and interest payment delays. Thus, while asset valuations have continued to correct in 2024, the necessary climax of the market clearance phase has not yet occurred.

4. Opt for financing with collateral

In a financial environment where European economic fundamentals are still fragile but where market expectations are already very positive, a cautious approach is to be preferred. In this sense, attaching real and exercisable collateral to the loans granted makes it possible to minimize losses in the event of an adverse scenario in which corporate default rates increase. Thus, the recovery rate of debts without collateral is historically only 30%-40%, while that of debts with securities taken on the shares of the operating company reaches 60%-70% and that of debts with securities taken on real assets (machines, stocks, etc.) is close to 80%-100%.

While the presence of security interests is theoretically reassuring for the creditor, in practice its exercise can be complex. Proven experience in this area with in-depth knowledge of collection mechanisms and legal procedures is a prerequi

The selectivity of applications on their purely credit aspect remains an absolute imperative. Adverse selection situations should be avoided, such as those where only companies that have not obtained credit from banks agree to borrow from investment funds by giving them collateral assets. As banks have eased their lending conditions, this risk should be less significant than in the past. In order to maintain a high degree of selectivity, it will remain essential to rely on a wide range of origination channels.

Thus, by maintaining a probability of default identical to that of the unsecured debt markets but achieving very low levels of losses in the event of default, this type of strategy makes it possible to obtain returns equivalent to, or even higher than, those of speculative credit, with a cost of risk close to that of the investment grade universe.