

The Insight: Conversations – Europe with Nael Khatoun, Madelaine Jones, and Suzana Perić

Harry Whitelaw

Hello and welcome to *The Insight by Oaktree Capital*. I'm Harry Whitelaw, and welcome to a new year of podcasts. We're excited to be opening the year with a Europe special. We'll take a look at the evolving European economic backdrop and review the outlook for the region's credit markets.

Joining to help unpack the nuances of European credit, we have Nael Khatoun, Portfolio Manager for European Private Debt; Madelaine Jones, Portfolio Manager for European High Yield Bonds and Senior Loans; and Suzana Perić, Oaktree's Co-Head of Sourcing and Origination. Great to have you all here today.

Nael Khatoun

Great to be here. Thanks, Harry.

Madelaine Jones

Thank you, Harry. Happy New Year.

Suzana Perić

Thanks, Harry.

Harry

Let's start off with the state of the European economy. A few years ago, things were looking a little precarious, but it feels like we've since found some stability.

Madelaine

Well, I think that's right. I would probably argue that sitting credit, we're a little bit removed from caring whether they're growing at 2%, 3%, 4%, or we really just need companies to be in an environment which is stable, which is not too punitive or facing too much of a downturn, and we certainly haven't had that.

What we haven't had is the more optimistic backdrop that the US has benefited from. But I think in some ways, that has been a slight blessing for the way management teams have conducted themselves. We haven't had an easy backdrop. There's been the Ukraine invasion after Covid. There was the LDI fallout. And I think all of those made management teams a little bit more conservative. Balance sheet, management, looking at extending maturities, preserving liquidity. All of that in mind has left us with an okay credit backdrop and companies which are quite well financed. And you can see that in evidence in default rates, which have been fairly low.

Nael

And I tend to agree with what Madelaine just said. Very often, the correlation between GDP and private credit volume is confused. GDP growth is generally a contextual factor rather than a direct strong determinant of activity. If you look at 2025, we had a really interesting economic, geopolitical, and tariff backdrop, yet direct lending volume in Europe reached an all time high, and you ask yourself why. And quite simply, I think stable monetary policy was definitely a factor in driving some of the spike in refinancings that we saw.

And the view from the ECB at this point is that inflation should probably hover around the 2% target in the medium term, therefore no real urgency for rates to move in either direction. And probably this similar message in the UK where the Bank of England has gradually been cutting rates since the summer of 2024. So when you put all of that together and you layer on top the potential fiscal stimulus in parts of Europe, it certainly feels like a more stable overall monetary policy environment.

Harry

That's great. And if we look country by country for a moment, one thing that probably would surprise us if we were speaking a decade ago, Southern Europe, termed a bit unfairly the PIGS maybe, have been in real bright spot, right?

Nael

So look, Southern European economies, in particular Spain, Portugal, and Greece, have performed particularly well recently, and they've definitely outperformed their Northern European peers. Now, much of that robust GDP growth is directly driven by quite resilient service sectors, in particular tourism, tech, and finance. And some of that is actually structural. So if you look at the Italian market as an example, regulatory and legal changes have transformed those markets quite a bit. So in Italy, borrower-friendly restructuring laws that have long deterred private credit funds have now been put in place.

And then for the other part of the equation, which is the economies that have been a little bit more challenged like Germany and France in particular, I'd expect some of the policy-led initiatives to lead to opportunities. And we're already seeing signs that government investment in infrastructure in energy transition and in defense is creating new demand for flexible capital solutions.

Harry

Well, we should talk about Germany. I guess the big one, probably the strongest European economy of the 2010s, great recovery from the GFC, now looking in a little bit more troubled with those headwinds.

Suzana

Germany has been resting on its hard work for a long time. There has been a lack of innovation and investment for over a decade. And it seems that we are waking up slowly to the new world. As Nael mentioned, we are seeing a big investment program in Germany coming down the pipe, addressing big capex requirements, including in the data center, financing and defense expenditure, and especially digital infrastructure build-out space as well.

Madelaine

I think unfortunately for Germany, a lot of its strength relied on an industrial base, which was heavily supported by an attractive energy backdrop. And some of that became unpicked after the roots to cheaper energy were cut off post-Ukraine invasion. So I think that's put it in a difficult place for some of its natural advantage in the autos industry, some of the heavy industrial sectors that it's been so successful at.

I think I'm a long-term optimist that Germany will reestablish itself. So it has a lot going for it, including, as Suzana alluded to, excellent fiscal situation, which a lot of our economies would be very jealous to have. So it has the firepower to support business and reposition itself. I think a lot of this is structural and will take quite some time. But in amongst that, I think as we are lenders, we will find pockets and places which will get support from that fiscal backdrop, maybe the construction end of the market repositioning, which could really be interesting as we delineate performance and find opportunities out there.

Nael

Madelaine, I particularly agree with your point around Germany having a lot of future potential, particularly as it relates to the case in point around where monetary easing could have a significant impact.

Harry

Well, let's take a look at sector by sector. So Madelaine, what industries are you viewing as the stronger side and the weaker side right now in Europe?

Madelaine

Across Europe, I think you've got to do a bit of both. You've got to do country and sector. We're fairly sector agnostic. If we find a good company with the right balance sheet, we stress test it, make sure it can manage through varying different environments.

Where we, because we're always focused on the downside, we'll look at the negative ends of the market and there's places like construction industry potentially bottoming out this year could be interesting, but it's still quite challenging. Chemical sector has a major cyclical downswing, which we hope may find its bottom this year, but given it's so much determined by what happens in the construction market and what happens in the autos market, that is also facing quite a lot of challenge. Those two sectors, I think are taking up a lot of our time to piece through because in amongst the challenging parts of those markets will be some companies which are very, very well adept to ride through.

We're in syndicated loan market, the high yield bond market. These are not small companies. These are the big companies with lots of firepower, lots of balance sheet liquidity, good management teams, long histories that we can look at, and we can delineate which ones of those can make it through and potentially find some attractive discounted opportunities. But by and large, it will come down to balance sheets more than it will do top down because we're in credit. We're not looking for the upswing. We were looking for really piecing together where the cash flow can support current yield.

Harry

That makes sense. So that's a brief backdrop on the economic side. Let's talk about the credit markets themselves. What's actually the makeup of the European credit markets? What are we dealing with here? Nael, why don't you start on the private side, first of all.

Nael

European private credit today continues to be largely dominated in terms of AUM and deployment by sponsored back direct lending. Today, Europe is the second-largest direct lending market globally. The market stands at \$400 billion. That compares to \$1 trillion in the U.S. That's a really interesting comparison because both regions actually have similar sized economies. So therefore it begs the question, why the size differential in private credit?

The answer is relatively simple. It comes down to the fact that Europe has a very strong historical and continued reliance on banks as the primary financing source. As we think about the market, we're also often guilty of speaking about Europe holistically, but the reality is that penetration and growth of direct lending, it hasn't been linear across countries.

UK, France, and Germany are the most mature markets and they dominate. They account for 60% of total volume. On the other hand, the fastest growing markets over the last 12 months, at least, have been Netherlands, Italy, and Spain, each of which has experienced close to 50% year-on-year growth. Part of what makes Europe so interesting to navigate is exactly the different trends in risk/reward at any given moment in time.

Suzana

Just to add to what Nael just mentioned, so the European private credit market still remains surprisingly much less crowded than the more mature U.S. market. This is partly because of the European market being more complex. This complexity creates great opportunities, especially for asset managers with local expertise and deep relationships across the various jurisdictions who are able to navigate different languages, cultural differences, and local regulatory and legal regimes.

Harry

So that's the private situation. Madelaine, what about the liquid credit side?

Madelaine

We all may still remember high yield bonds being classified as junk territory, but really when you look at it today, its evolution is remarkable. Now over 50% is BB territory. It's very liquid. It's changing nature quite considerably from when we started out investing way back in 1999. Loan market, likewise, has changed. I think in some ways it's seen its credit quality deviate more to a single B market.

But what I would point to in terms of quality is how much bigger the companies are that we were investing in way back when I started investing in 2003. The size of the companies we were investing in was 50 million, 60 million. Those kinds of companies have gravitated more to be served by the private debt market, which makes absolute sense. Our cohort has increased in size to being over 600 million size EBITDA. Bigger size means you may be more diversified. You have more capital available at your fingertips. You've got more optionality in times when they're more challenging.

So we've liked the evolution of the loan market as well. The loan market is notably less volatile than the U.S. market because we don't have as many retail investors. There's an inability for retail investors to access the asset class. So you don't see inflows and outflows in the same way. We're very much underpinned by what's happening in the CLO market.

Harry

So let's turn to the supply side and the question of how we deploy private and liquid credit capital. Nael, we were looking at this before. Most people would probably be surprised just how much European PE dry powder is out there. Is serious LBO activity going to arrive in '26?

Nael

Well, that's a great question. And it feels a little bit like Groundhog Day, to be honest. So sitting here at the beginning of 2025, I would've said that the wave of M&A that was supposed to spur new LBOs didn't quite reach us. And frankly, a year later, to be honest, it still hasn't. So some cell processes never launched because sponsors didn't see favorable valuations. Others got pulled halfway. But as we discussed briefly before, one would expect that the more stable monetary policy should help spark M&A going forward.

As you rightly mention, PE dry powder is not the issue. And on the other hand, I think we often get a little bit too carried away with M&A statistics. The direct lending market has shown a remarkable way to compensate for that volume and had a record year last year with a change in mix. So as new LBOs remain subdued, for the first time I can remember, in Europe at least, bolt-ons and refinancings overtook new buyout financings.

Harry

Suzana, anything to add on the sponsor front?

Suzana

Judging by what we've seen over the last couple of quarters, there has been a meaningful uptick in M&A activity compared to a year ago. Having said that, I think we will continue to see sponsors exploring creative solutions outside of M&A, such as continuation vehicles, NAV financing, or minority sales to generate liquidity and also extend hold periods, particularly for assets that are still growing into their valuations. I think an encouraging point is that the IPO market has started to reopen somewhat. So we hope that, that development continues into the next year and will provide sponsors with alternative exit routes.

Harry

And when we're talking about the sponsor community, Suzana, it's not just local European sponsors we're talking about here. These are global sponsors often U.S. headquartered that want to access Europe as well.

Suzana

Yeah. We are seeing a big shift with sponsors coming from the U.S. and looking to invest and find value in the European market. That's a big trend and we certainly see that continuing.

Nael

The continent's geography often allows incumbent businesses to be more powerful and better protected than the U.S. due to market inertia that exists between the different nations. So that could be labor, it could be language, it could be many things. And this slower moving environment favors national champions and therefore it supports a strong base of high quality companies that could be potential targets for large private equity sponsors.

Harry

So we're expecting decent supply in Europe in '26. Let's talk now about the nuances of investing in the European credit market. Madelaine, the first thing to say is the European credit market is really many markets. What are the considerations for that as an investor?

Madelaine

Well, that's so true. I think that's one of the great joys of operating in the European market is that when we talk in a Europe overall way, there's actually many things going on there. And not only can you think about your portfolio positioning across sectors, but you think about it regionally as well. And we can lean into certain jurisdictions where we feel they are more favorable or better positioned or the macro environment feels more compelling. So we think of things in healthcare across Germany, maybe different to healthcare in France. And that means there's just more to do. It gives us more opportunities to add value.

Harry

So we know European credit maybe can sometimes be a little bit overlooked, but how do you consider the relative value of Europe right now?

Nael

Well, from an investor perspective, as the second-largest direct lending market, Europe has certainly matured enough to justify consideration. And perhaps the question we should be asking ourselves is where we're seeing demand from investors, because often that's the best guideline. And for many European LPs, Europe is actually already a firmly established part of their portfolio. For non-European LPs, it's certainly growing. But another interesting trend that we're seeing is that investors are no longer bifurcating their portfolios and asset allocations in the same way.

Historically, there's been lines drawn between U.S. and non-U.S. containers, as well as components of the portfolio that are private or public. Increasingly now and very clearly in credit, we begin to see the blending of both and increasing demand for global exposure, and that's partially driven by the recognition of how far the European market has come.

And a related point to this is we also see quite a surge in demand from our institutional investors for global multi-strategy credit portfolios. And as an aside, I think this last point is a particularly interesting one for managers because as GPs and LPs consolidate their relationships, platforms with the ability to provide LPs with multi-strategy global exposure across credit will be really well-placed going forward.

Madelaine

I totally agree with that. I think added to potential opportunities of volatility or dislocation or relative value that present when you have a bigger spectrum to work within, you also have that diversification. So you can just add to the portfolio a fundamentally beneficial attribute of diversification just by spreading that bandwidth. And given that we do things across Oaktree in a very familiar and similar fashion, the relative value conversation is very fluid.

And it means when we're talking about credit in the U.S. and looking at it in certain way, we're looking at it with the same lens and framework of bottom up, risk control, default avoidance, and it becomes a very linear conversation with which to talk diversification fluidly and relative value in a very fine way.

Harry

So does the fundamental strength and that spread premium of Europe make up for it being a slightly smaller, less liquid market?

Madelaine

I believe so. I think the spread premium is there, and I think it would be foolish to overlook the value of diversification plus the spread pickup. I think when it's done with skill and with a heritage of understanding the complexities of the region, I think it presents a great opportunity. We see it more and more. I think there's a growing conversation around rebalancing the overindexation to the dollar. That's a thematic some of our investors have brought up.

And when we look across the opportunity set, we see Europe default rates have been very moderate. The depth of the market, the functionality of the market, the understanding, the predictable fiscal and monetary backdrop that we have in recent times lends itself very well for that rebalancing and repositioning that we think is happening now.

Suzana

Yeah. Maybe to add on that note, it feels like there's still a lot of wide space in Europe to grow. Nael mentioned previously that Europe still very heavily relies on the banks. I expect private credit lenders to take increasing market share from banks.

Harry

Nael, now what's the key to navigating the next phase of European credit?

Nael

Well, look, on the whole, the prospects for European private credit remain very attractive. But I do relate to your description of the next phase. As the market continues to mature, the key to navigating this environment is really to rely on managers with sophisticated risk management. We're starting to see some cracks in portfolios with more borrowers feeling the impact of elevated rates. And the best evidence of these liquidity pressures is the increasing demand for PIK only structures.

Yet the majority of participants in direct lending are new entrants in the last 10 years with very little, if any, experience of cycles, nor in-house resources to deal with potential restructurings. In Europe, that risk is particularly amplified given the complexities we discussed and the absence of an umbrella framework like Chapter 11. So it's a time to be thoughtful, defensive, rather than lean in at all costs. I think at the same time, it's equally important not to get too carried away with the negative headlines. When an industry grows this fast, it's natural that there are going to be some bumps along the way.

As Howard has said in the past, in real life, things fluctuate between pretty good and not so hot. But if you read the narrative around some of the defaults, things go from flawless to hopeless overnight. And the question is whether this is a sign of a systemic issue. And the answer from my point of view is no, it was just suboptimal underwriting. So fundamentally, with the right skills that Madelaine referred to, the European direct lending market offers a tremendous opportunity.

We're certainly very excited about what's still to come, and I'm frequently asked how to contextualize that enthusiasm. And while it's a relatively simple measure, I often point to the fact that direct lending assets as a percentage of GDP are 3.4% in the U.S., but there's still only 2.2% in Europe. So in short, still a market with huge growth potential.

Harry

And Madelaine, game plan for navigating liquid credit in Europe over the next few years? What's going to be the key to success?

Madelaine

I think leaning into some of that conversation of private credit is always to stick to what you do well. And for us, that means dissecting credits in a very careful and disciplined way and focusing on that and not being caught up in a market which is trying to reach or not being aware that there is a lot of demand for the asset class. I think there is a lot of demand, whether you look at private credit with its syndicated loans, high yield bonds.

I think demand has, in some ways, outstripped some of the supply we might want to see. And within that environment, you have to have your senses even more heightened to what could be a relaxation of standards. I agree with Nael. I don't think that there is an endemic problem here, but it just means we have to be very, very careful, restrain ourselves, remain selective, pass through because within all of the universe, there's lots and lots of good things that we can piece together very robust portfolios with.

Harry

Fantastic. That's a great place to wrap up today's episode. We hope it's been a useful insight into the nuances of European credit markets.

Thanks to Nael, Madelaine, Suzana, and thanks to you all for listening in. Look out for future episodes wherever you get your podcast or via the Oaktree public website.