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PEMBERTON
Connecting Capital Across Europe

Pemberton Perspectives

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Discussing some key investment themes in European private debt

Direct Lending – a Relative Value Play

Private debt, we believe, is more attractive than other private and public asset classes on a relative value basis.

1. Comparing *private debt* to *other private markets* is hard given their opacity but they represent a key input into the asset allocation decision. *We believe private debt risk-adjusted returns are very favourable compared to Real Estate and Private Equity.*

2. Comparing *private debt* to *public debt* is possible given our own proprietary deal database. *Loss-adjusted returns compare very favourably to public debt markets.*

"Mid mid-market" terms on deals up to €100m remain relatively stable"

"By Sharpe ratio[1], European public debt outperformed listed equity & US public debt"

3. Comparing historical risk-adjusted returns between *public debt* and *public equity* markets is more straightforward. Ranked by Sharpe ratios over the last 15 years, *European syndicated debt markets have outperformed their public equity counterparts and US debt equivalents*[2].

4. With 3% yield pickup for USD investors, European direct lending is attractive for international investors.

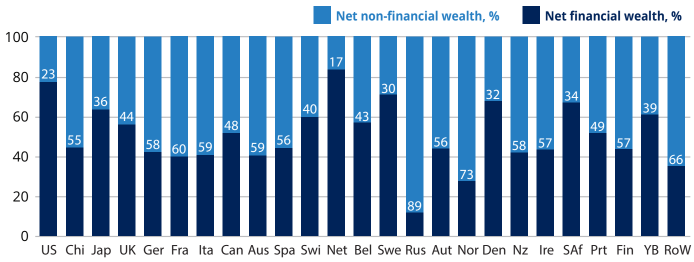
Pemberton has developed an on-the-ground European offering, providing deep access to the local "mid mid-market", the core of European private debt. This differentiated origination approach provides access to a market where pricing and terms remain relatively stable.

[1] The Sharpe ratio is the average return earned in excess of the risk-free rate per unit of volatility
[2] FTSE 100 index used as proxy for public equity, ELLI, LLI and ML HY indices as proxies for syndicated debt

1. PRIVATE DEBT VS OTHER PRIVATE ASSETS

- Since 1996, **Global PE** has seen just one year of median net IRR above 15% (2011 – 15.3%) with average net IRRs of 11.6%[3]. Traditional structures target 10-year investments and 20% IRR. However recent trends have been towards longer and lower-yielding funds (recent examples include a marquee 14-year fund targeting 12–14%)[4].
- **Distressed debt funds** have a typical return target of ~12% EUR equivalent, though since 2000 the Eurekahedge Distressed Debt Index has returned an annualised 8.6%. Substantial levels of dry powder in the strategy, coupled with an ELLI distress ratio of 0.9%[5] (a post crisis low) suggest achieving target returns will remain challenging.
- The average **European prime office real estate** spread to government bonds is below 3%[6]. While typical LTVs are lower than leveraged loans, returns for Real Estate debt are materially less than comparable cashflow based corporate lending. This is true even after adjusting for historic credit losses. Real Estate is also less liquid.
- Typical **NPL funds** target 8–10% EUR returns and require an 8-year lock-up of capital[7]. Returns are inherently uncertain given their non-performing nature, as opposed to contractual interest payments in par lending strategies.
- On a global level, the scale of private non-financial assets is remarkable at ~50% of net wealth. This includes real estate, art, wine, watches, jewellery, cars and jewels among others.

GLOBAL BREAKDOWN OF INVESTED ASSETS – FIN vs NON-FIN



Source: Davies, Lluberas and Shorrocks, Credit Suisse Global Wealth Report 2017 and Credit Suisse Global Wealth Databook 2017; *YB = Yearbook and RoW = Rest of World*

As an aside, returns have been impressive (a 10yr car index has returned 334% over the period, though ultra long term (100+yr) returns have nonetheless lagged world equities[8].

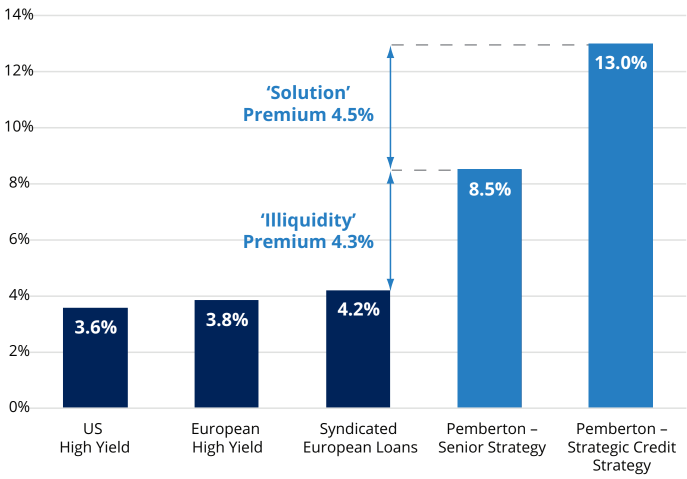
- Direct lending strategies target 8.5%–13% EUR returns and sit ahead of 50% equity buffers[9].

2. PRIVATE DEBT VS PUBLIC DEBT

- We believe there is a material pickup associated with investing in private debt as compared to syndicated markets. This pickup comprises an illiquidity premium of 4.3% and a solution premium of 4.5% for more complex situations or transition capital. Given lower leverage multiples, higher spread per turn of leverage and higher equity buffers in middle-market debt[10], this is hardly surprising. Further, default rates in the mid-market have historically outperformed large cap deals[11].
- Despite 2Q18 lender pushback, 80%[12] of syndicated loans in Europe are covenant lite. This compares to an average 1.4x covenants for recent senior strategy deployment at Pemberton.

“Private debt compares favourably to public debt even adjusting for historical defaults”

RELATIVE VALUE IN PRIVATE DEBT VS PUBLIC DEBT[13]



- While B-rated CLO tranches' returns are comparable to senior direct lending on a pre credit-loss basis, default exposure is non-linear given the subordinating effect of tranching (typical attachment rates ~81%). Assuming 75% recovery rates, a typical B-rated CLO tranche returns 0% once the default rate exceeds ~13.2%[14].

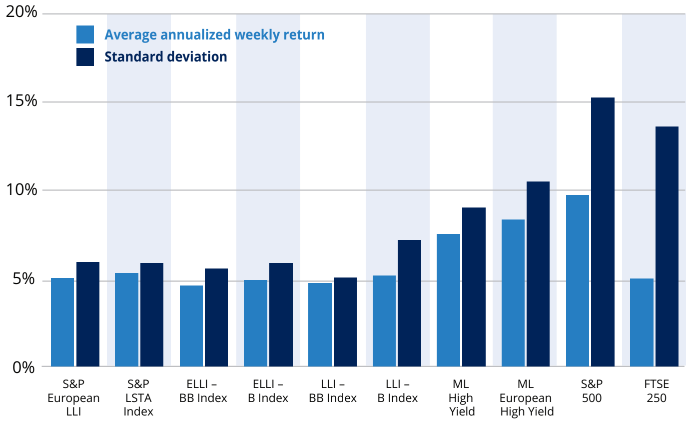
3 Source: Preqin
4 Source: https://www.ft.com/content/918d6562-9983-11e6-8f9b-70e3cabccfae
5,12 Source: LCD, Q3 2018
6 Source: Cushman & Wakefield Research, Oxford Economics Dec-17
7,9,10 Source: Internal Pemberton Data
8 Source: Dimson, Marsh, Spaenjers and Staunton, 2017
11 Source: Nuveen, TIAA, 2017
13 Source: LCD and Internal Pemberton Data
14 Source: Natixis Asset Management

3. PUBLIC DEBT VS PUBLIC EQUITY

With Sharpe Ratios ranging from 0.55 to 0.64[15] European leveraged loans and HY have materially outperformed the S&P500 (0.43) and the FTSE (0.26). Yields currently available in public HY indices are near all-time lows. Earning yields on European equity indices currently average ~6.5%[16], meaning material growth must be assumed to compete with direct lending strategies that offer ~8.5% to ~13.0% gross IRR, are senior in the capital structure and have ~50% equity buffers. For context regarding growth, Euro area GDP in 2Q2018 came in at +0.4% QoQ, in line with 0.4% in Q1[17].

Reflecting the most senior ~50% in the capital structure and thus directly subordinating the equity components, leveraged loans are materially more defensive in the face of unforeseen underperformance than equity.

RISK RETURN IN PUBLIC DEBT AND EQUITY



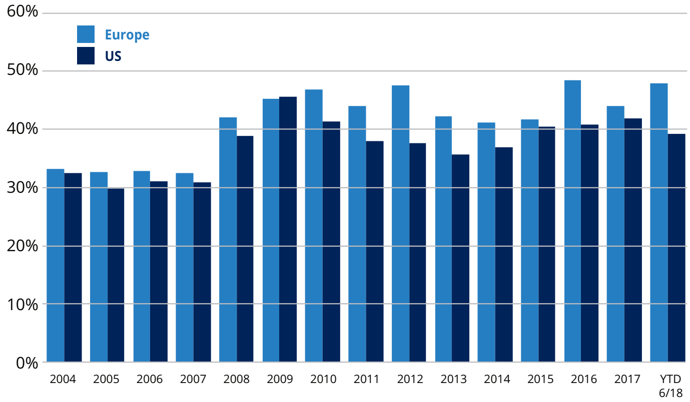
Source: S&P European Leveraged Loan Index & S&P/LSTA Loan Index

4. US VS EUROPEAN DEBT

- On a Sharpe Ratio basis, European leveraged loans and high yield have also outperformed US syndicated debt markets[18].
- The mid-market premium in the US is estimated at 39bps[19], materially lower than our estimate for Europe (430bps), albeit we expect the European premium to reduce as the market develops.
- Spread per turn of leverage is higher than in the US, despite currency basis suggesting the opposite should be true (72bps in Europe, 67bps in US)[20].
- The average equity contribution for sponsor backed, syndicated transactions is materially higher in Europe than the US. This has been true in all but two of the last thirty quarters. (See chart, right).

Pemberton continues to see European mid-market direct lending as the best relative value play in credit. This is especially so for US based investors.

AVERAGE CONTRIBUTED EQUITY



Source: S&P Global Market Intelligence

[15,18] Source: LCD, Q2 2018, base date of 31st Dec 2003
[16,17] Source: Bloomberg database Sept 2018
[19] Source: LevFin Insights
[20] Source: LCD, Q3 2018

DISCLAIMER

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These are just a few thoughts based on our view of the market.

We'd love to hear your opinions. So please feel free to contact our Investor Relations team on ir@pembertonam.com or +44 (0) 20 7993 9300 with any questions or comments.