November 2017

PEMBERTON
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Pemberton Perspectives

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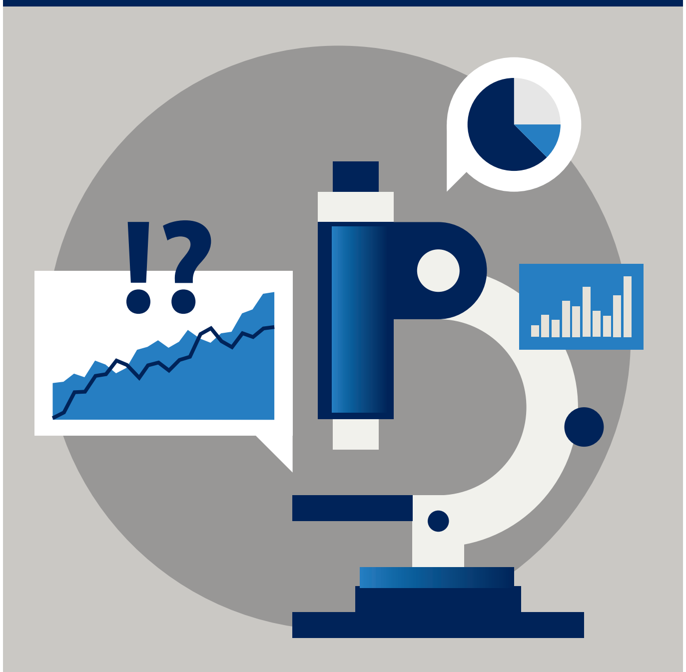
Discussing some key investment themes in European private debt

Five of the more common myths about private debt today

We share below some of our observations on the private debt market, and more specifically, some of the myths that we have encountered during our many discussions with investors over the past few years.

We believe that a key challenge for both investors and borrowers is that the private debt asset class is still relatively opaque. As a result, a number of myths and misconceptions arise, some with little or no merit, and this can lead to ongoing confusion.

1 You can't rate sub-investment grade loans accurately



There is a growing view that there is not enough clarity and transparency in this market and therefore a need to more accurately and objectively predict who is likely to default and why.

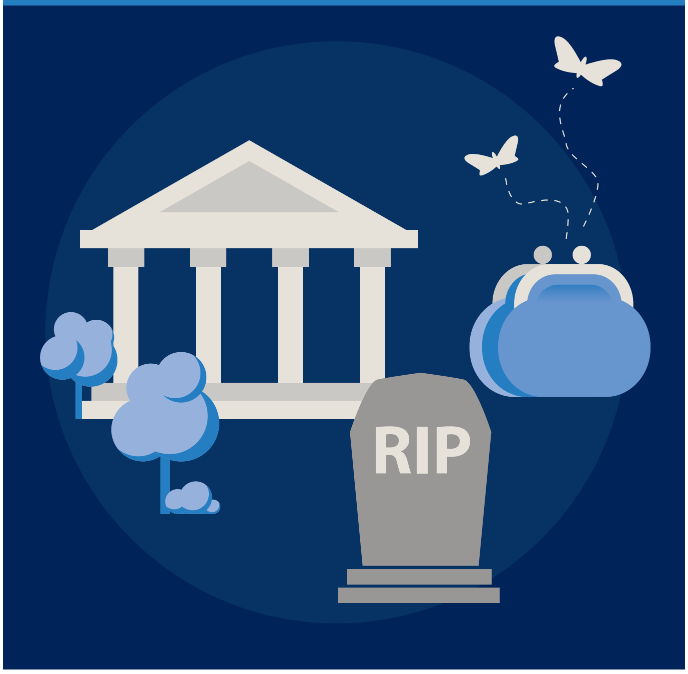
However, it is not easy to rate mid-market sub-investment grade borrowers. Ratings agencies do not typically cover the sector in detail, leading to the belief that accurate ratings are impossible.

This leads people to believe that there is little or no transparency on the underlying risk with private debt portfolios, as there is a lot of subjectivity and all sorts of judgements that need to be made about management capabilities, market standing, legal and policy risks, which further complicate the task.

The way we see it:

The better your rating model, the more accurate your ratings. Our model uses data from 38,000 European corporates and has a 19 year track record in providing accurate mid-market ratings, which means investors get a clear view of the risk in our funds.

2 The banks are dead...



Probably the myth that we have heard the most over the past years, and one that still pervades in many discussions as investors try to get their heads around the current competitive environment.

The reality is that this myth did have merit about three years ago, but the banks have come roaring back since then and any league table will evidence their dominance across the European market.

This is not all bad news for private debt managers however as the banks still have limitations to their lending capabilities. Nimble managers will always be able to find good investment opportunities across the market.

The way we see it:

The banks are very much alive and kicking, and this shows no sign of changing at present. We believe working with banks can provide valuable access both to non-sponsor backed companies and to deals where there is less competition to provide the financing.

3 Some countries in Europe are still "no-go" for direct lenders

The media is full of negative stories about the economies of Italy, Spain and Portugal. Multiple legal and political difficulties add to the economic uncertainty about them. Together, these factors often cause people to think of these countries as off limits for direct lenders.

The reality is different. Lots of companies in Southern Europe are just as strong, dynamic and growth-focused as any UK, French or German business, and many of them have a global footprint and generate diversified international revenue streams. The challenge is to find these companies to invest in, and being local is almost always the best route to successful origination in these countries.

There are also many ways to ensure that the legal protections in deals in these countries are robust, and recovery rates in these countries support this approach. Recent changes in the Italian legal regime have further strengthened lender rights.

The way we see it:

Direct Lenders in Europe are starting to fully embrace deals in these countries as there is a growing recognition that high-quality businesses exist and are flourishing. Local experience and expertise is crucial to find and assess the best quality companies.

4 Sponsored deals are better than non-Sponsor deals

Deals that are 'sponsored' by private equity groups are often thought to be better than ones that are done directly with private companies. The thinking goes that private equity firms have experience in growing businesses, and with deep pockets, will step in to support them if things start to go wrong.

So, are sponsored deals superior from a debt lender perspective?

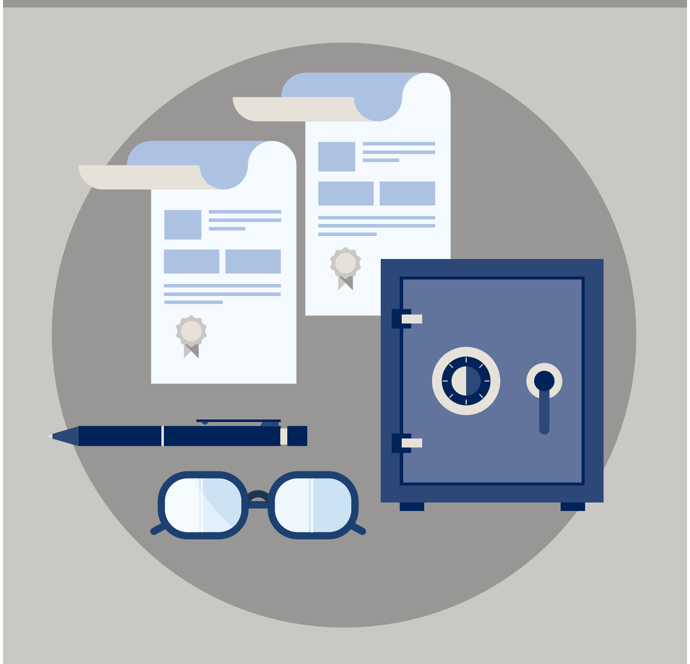
In reality, no. You get great private equity deals and you get not so great ones. The challenge is identifying and evaluating the best opportunities, sponsored or unsponsored. This is borne out by Moody's, which finds no difference in the recovery rates in defaulted US private equity deals when compared to non-sponsor deals.

Because many non-sponsored deals are recaps, rather than competitive auctions, they can often offer better value for investors too.

The way we see it:

Rather than just focusing on 30 or 40 private equity companies, you can find opportunities to lend directly to the thousands of high quality mid-market corporates across Europe who have no need for private equity capital and the associated equity dilution.

5 Having a smaller number of maintenance covenants in a deal means it is a "Cov-Lite" transaction



Deals that are 'Covenant-Lite' or 'Cov-Lite' are increasingly prevalent in the European market. We believe the use of the word "Lite" can be misleading as it infers that there is at least one proper maintenance covenant associated with the deal, but it may be simply less onerous on the borrower.

The reality however is that 'Cov-Lite' deals have no maintenance covenants at all. Lenders therefore have limited ability to protect their value in the context of underperformance. In liquid loan markets, of course, investors could always sell out to recover value. The difficulty is in illiquid markets, where investors are locked-in for longer terms and have no ability to take action.

The way we see it:

'Cov-Lite' is a misleading term and although such deals do have a place in the market, deals of this type have to be considered very closely when investors are being asked to lock up capital over many years. Covenants are the foundation of the loan asset class and are the tool that allow lenders to keep the management on track, and ensure a successful long-term investment.

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

We'd love to hear your views as we revisit some of these themes over the coming months for our Pemberton Perspectives series. So please feel free to contact our Head Of Investor Relations, Mike Anderson on +44 (0)20 7993 9311 or mike.anderson@pembertonam.com with any questions or comments.