

## Is it a good time for subordinated debt?

Over the past 20+ years and at different times in the economic cycle, MV Credit has often been asked if subordinated debt has a future. Whilst the market has evolved, with the toolkit expanding from mezzanine, to include second lien, PIK, and preferred equity instruments for instance, it has continued, ensuring that subordinated debt instruments prevail as relevant investments and financing solutions.

MV Credit estimates the European subordinated (also known as mezzanine or junior) debt market at around 10% – 15% of the total corporate private debt market, therefore representing a specialist segment within the asset class<sup>1</sup>. It consists of a limited number of non-bank institutions with different focusses on geographies, transaction sizes and risk/return requirements (e.g. equity-like strategies vs. credit-driven approaches). As a subordinated debt expert, MV Credit believes that the solutions lenders can offer makes it attractive to both investors, by pricing a premium, and (private equity) sponsors in search of tailored financing.

### Where does subordinated private debt sit in the debt market?

#### A specialist market

While the senior debt space is shared among banks and private lenders, subordinated debt is primarily provided by lenders such as MV Credit. Most banks are reluctant to provide this type of subordinated solution primarily due to the illiquid nature of the debt and its high capital requirements on their balance sheet.

Private debt lenders can bridge this financing gap by providing tailor-made solutions to sponsors and borrower companies, certainty on economics, legal terms and certainty of deliverability during the structuring processes. Subordinated debt financings are negotiated bilaterally between sponsors and a limited number of private debt providers. As sponsors tend to have existing precedents with selected subordinated debt providers, each financing process may involve only a modest number of potential providers. The majority of the private debt fund lenders are focused on senior direct lending, rather than managing dedicated subordinated strategies like MV Credit. MV Credit is typically the sole or lead arranger in subordinated transactions<sup>2</sup>.

In addition, subordinated lenders offer the typical private debt advantages to borrowers such as:

- Providing flexible debt structures (e.g., cash vs. PIK interest) with known precedent documents;
- Providing financing in size;
- Providing multiple currencies (e.g., EUR, GBP, USD);
- Speed of execution, length of credit processes and direct access to decision makers;
- Existing relationship with corresponding sponsor through repeat transactions.

#### A complementary offering to senior debt

First and foremost, relationships with sponsors play a key part to enable privileged and early access to subordinated origination. However, the nature of the senior lenders in the capital structure can vary, subordinated debt can be placed alongside both private senior debt and senior syndicated debt, especially in the mid to large cap transactions. In recent markets, the more expensive pieces of private senior debt, typically unitranche, have opportunistically been refinanced in the syndicated market at a tighter pricing and leverage. While there is depth in this market, the appetite for leverage can restrict the amount raised in private markets, potentially leaving space for a turn of junior debt and creating an opportunity for subordinated lenders to bridge the gap. Other times, subordinated debt sits directly behind a senior or unitranche debt provided by a club of lenders.

The competition between traditional subordinated debt lenders in Europe has remained stable overall. MV Credit attributes this to a number of historical players exiting the market to focus on senior direct lending and lower mid cap strategies or private equity strategies after the financial crisis and the segmentation of the landscape by size (large, mid or small cap) or geographies (national, Pan-European or US-focussed players). In this specialist market, having a long track record and lasting relationship with sponsors, through the good times and when managing tougher situations is more relevant than ever.

<sup>1</sup> Prequin, out of c.€100bn private debt market. Data sourced: November 2023.

<sup>2</sup> Over 50% of invested amount, MV Credit proprietary data. Subordinated transaction in the period of September 2021 – September 2023.

## Why do sponsors add subordinated debt to the capital structure?

### Permit growth investments while alleviating pressure on company's cash flow

Sponsors may acquire companies with the aim of executing a transformation plan, which in many cases include consolidating a fragmented market through an accelerated acquisition strategy. This can be funded with the cash flows generated by the borrower and/or debt raised to finance such acquisitions. Unlike most senior debt, subordinated debt can provide flexibility to capitalise interest (non-cash PIK) allowing sponsors to execute buy-and-build strategies by alleviating cash flow pressures.

Similarly, subordinated debt can fund expansion capex plans (i.e. building or acquiring a new site) or extracting synergies from mergers of two companies, without additional pressure on cashflows from incremental senior debt.

Ultimately subordinated debt is an effective tool for financing growth and remains less costly to sponsors than equity.

### Access cash generative high valuation businesses

Subordinated debt allows sponsors to invest in businesses with high valuations in attractive end-industries such as healthcare, software, business services or education (EV >12x EBITDA). Even in the current interest rate environment, the cost of subordinated debt provides an arbitrage against equity financing, considering the expected 15-20% returns of sponsors. Subordinated debt allows sponsors to differentiate and bid for attractive companies that otherwise their funds would not be able to buy given their fund size and target returns constraints.

We also note that as a lender, equity valuation does not drive how the credit risk of an investment is assessed. MV Credit focuses on fundamental credit metrics such as equity cushion. For subordinated transactions we looked at over the past five years, equity cushion remained above 50% with average debt multiples of c.7.0x<sup>3</sup>.

### Assist with capacity constraint

Sponsors' funds typically operate in 5-year investment cycles, after which their ability to provide additional capital can be legally or commercially constrained. In such scenarios, subordinated debt can provide a short-term bridge financing to allow them to execute the final part of their portfolio company's business plan (i.e. final acquisitions) ahead of a sale of the business.

## Why is subordinated debt attractive for investors?

### Attractive risk-adjusted returns

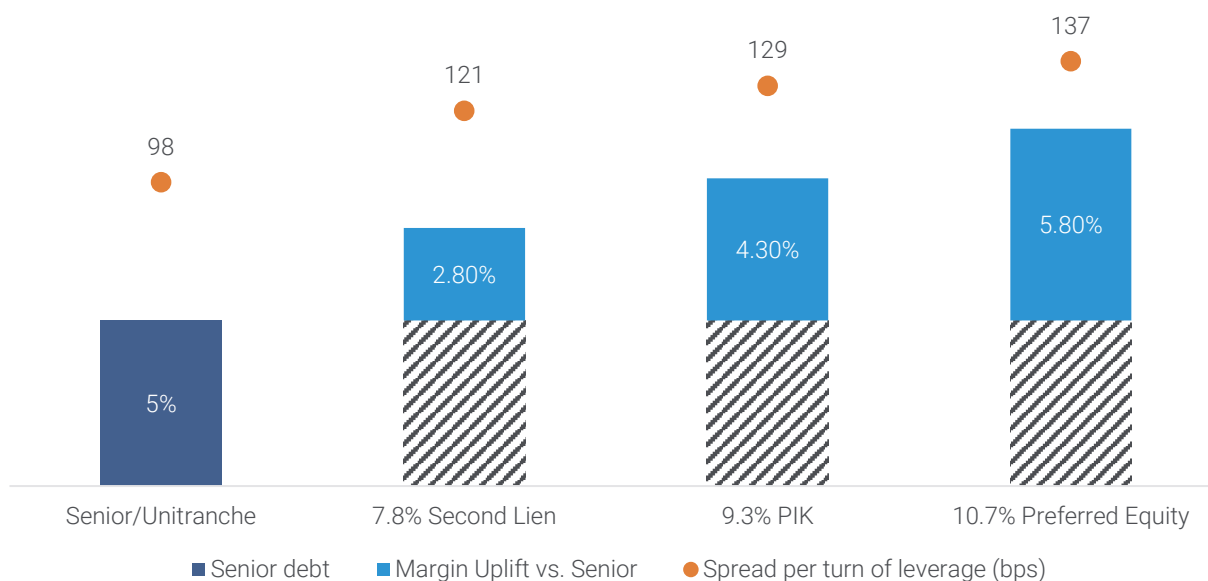
MV Credit believes that the illiquidity premium achieved by investing in private markets, in comparison to public securities, provides an attractive return per unit at risk taken. MV Credit does not believe this opportunity is easy to find in the public universe, where investment inefficiencies are infrequent. This premium is enhanced the more junior the instrument in the capital structure, where bespoke structures are bilaterally negotiated.

The gross yield of European subordinated debt instruments is currently between 13% to 16%, inclusive of the features listed below:

- Interest payments consist of a cash and/or payment-in-kind ("PIK") margin above the EURIBOR/SONIA/LIBOR base rate. The total margin is considerably higher than that of senior debt and high yield bonds, with current interest of EURIBOR/SONIA/LIBOR + [8.25-12.0]% (including the cash component) .
- MV Credit investments over the last 10 years demonstrate attractive margin levels (Figure 1), the more junior instruments benefit from an uplift in margin to remunerate the higher leverage exposure, this is measured by the spread per turn of leverage. PIK and preferred equity instruments can be 2<sup>nd</sup> ranking or rank more junior in the capital structure.

<sup>3</sup> Source: MV Credit, as at 31st December 2023

Figure 1: MV Credit's average total margin per instrument over the last 10 years<sup>4</sup>



- Instruments benefit from additional economic upside such as arrangement/upfront fees, we see them ranging between 2% and 3% of the facility.
- Subordinated debt usually includes non-call and/or prepayment penalty periods for the first 2 to 3 years, combined with upfront fees, it deters borrowers from refinancing the facility early and protect returns when markets reprice down.
- Unlike high yield and other fixed rate instruments, the floating rate nature of European private debt instrument provides investors with protection in a changing interest rate environment.

### Delivering consistent returns within private markets

Subordinated debt offers a similar sharpe ratio to senior strategies and a higher ratio compared to private equity strategies (Figure 2), indicating better risk-adjusted performance. The strategy has demonstrated higher historical returns compared to senior debt and a competitive return profile with private equity style yields without risk of valuation multiples. The distribution profile of private debt funds is more predictable and does not rely on an active M&A market to deliver. With similar levels of volatility and higher absolute returns than senior strategies, subordinated strategies are opportune to diversify a pure senior direct lending allocation and improve the overall returns of the asset class bucket.

Figure 2: Risk-return of subordinated, senior and private equity strategies (2002-2019 vintages)<sup>5</sup>

	Subordinated Strategies	Senior Strategies	Private Equity Strategies
Average Return	9.9%	7.3%	14.4%
Volatility	2.1%	2.0%	4.3%
Sharpe Ratio	4.8	3.7	3.4

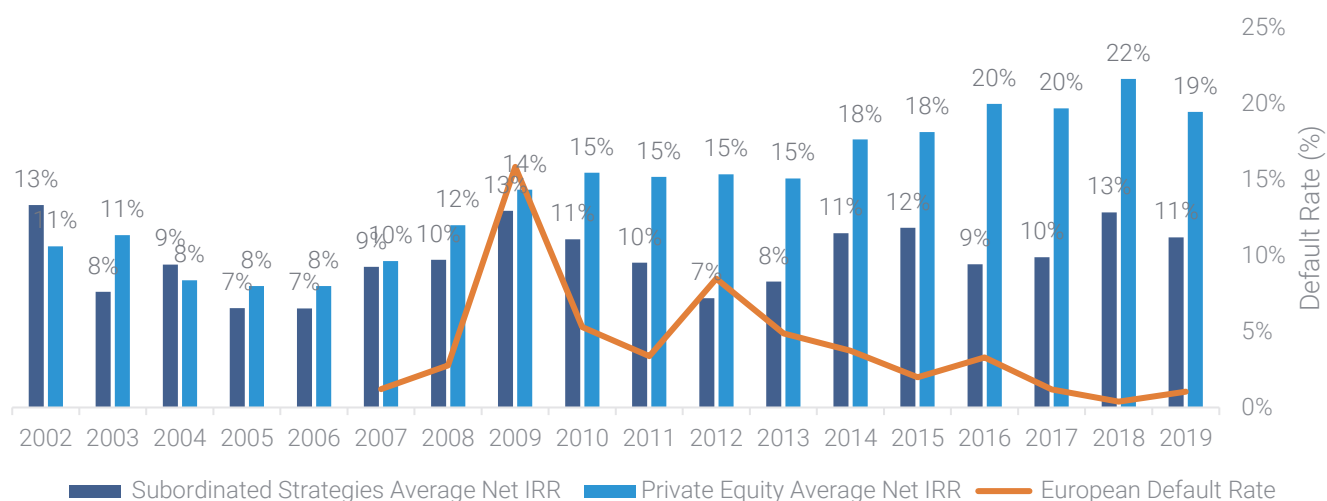
More strikingly, for 2002-2010 vintages that were invested during a high default rate environment (investment periods for subordinated and private equity funds are both typically 5 years), average returns were 10% for subordinated strategies vs. 11% for private equity<sup>6</sup>, showing that subordinated investors benefit from downside protection.

<sup>4</sup> Source: MV Credit, as at 30<sup>th</sup> September 2023. 10 years from 2013 to 30<sup>th</sup> September 2023. Total margin: PIK margin + Cash margin. Weighted average of MV Credit's invested amounts.

<sup>5</sup> Source: Preqin, as of November 2023

<sup>6</sup> Source: Preqin, as of November 2023

Figure 3: Average return per vintage year<sup>7</sup>



### Control Features and Information Rights

When investing in subordinated debt, the lender typically benefits from control features, often with a blocking minority stake. In addition, typically 100% of subordinated lenders will need to consent to certain actions such as extending the terms of debt, changes to pricing and waivers of default which provides investors like MV Credit with more control.

Experienced lenders in subordinated debt are in a better position to request additional information rights such as monthly, not quarterly, performance information to strengthen the monitoring of portfolio companies.

### Conclusion

Subordinated debt is a small but rich part of the corporate debt market. Successfully originating subordinated debt requires deep relationships with sponsors to enable privileged and early access to subordinated origination opportunities as they arise. Subordinated origination can be scarcer or lumpier than senior origination over a short period of time, however, the range of solutions enables managers to offer attractive terms to investors, deploy across macroeconomic cycles and answer sponsors' specific needs. Having raised and deployed five vintages of pure subordinated strategies, MV Credit is among a minority of managers who can demonstrate the track record necessary to offer expertise in this asset class.

<sup>7</sup> Source: LCD ELLI Default Rates, Preqin, as of November 2023

## Contact Details

MV Credit Partners LLP  
45 Old Bond Street, London W1S 4QT  
Tel: +44 (0) 20 3961 8820  
Email: [investorrelations@MVCREDIT.COM](mailto:investorrelations@MVCREDIT.COM)

## Disclaimer

This Document ("Document") is being provided by MV Credit Partners LLP ("MVCP") and MV Credit S.à r.l. ("AIFM") together referred to as MV Credit ("MV Credit"). MVCP is a firm authorised and regulated by the UK Financial Conduct Authority (the "FCA") with firm registration number: 67717. MVCP is also an Exempt Reporting Advisor (ERA) with the SEC. For additional information please see: <https://adviserinfo.sec.gov/firm/summary/28825>

The AIFM is a Luxembourg private limited liability company, authorized and regulated by the Commission de Surveillance du Secteur Financier ("CSSF") with a registered number A00002885. The AIFM has delegated portfolio management to MVCP for the MV Credit funds it controls. This Document is being issued on a strictly confidential basis to selected financial institutions and other parties considering entering into business relationships with MV Credit and may not be reproduced, distributed or published by any recipient for any purpose without the prior written consent of MV Credit.

- This Document is not intended to create any right of a legally binding or enforceable nature between MV Credit and the recipient in respect of the provision of services or products. This Document is being made available on a strictly non-reliance, no representations, no warranty and hold harmless basis only and will not be updated. The contents of this Document does not constitute professional advice, including but not limited to; legal, tax or investment advice and any recipient should consult with their own professional advisor before making any decisions relating to this Document.
- No liability whatsoever (for negligence or otherwise) is accepted by MV Credit nor any of the MV Credit affiliates for any loss howsoever arising, directly or indirectly, from any use of this Document or otherwise arising in connection therewith.
- By receiving this Document, you agree that you will, and will cause your respective directors, officers, employees, advisers, agents and representatives (together "Recipient Affiliates") to, (i) use such information only to evaluate the various funds and other products managed by MV Credit (the "Funds") and for no other purpose whatsoever, and (ii) keep confidential all information contained herein, and not disclose any information contained herein or derived here from to any person without the prior written consent of MV Credit (provided that you may disclose this Document on a strictly confidential basis to the Recipient Affiliates for the purposes of obtaining advice relating to the Funds). You further agree to promptly return this Document, together with any copies thereof (except as may be required for regulatory purposes), to MV Credit upon request.
- No regulatory body has reviewed or approved or passed opinion upon this Document or the merits of any investment discussed herein.
- This Document does not constitute a part of any fund document; nor is it a sales advertising document or a solicitation of offer.
- **The past performance of the Funds is not indicative of, nor a guarantee of the Funds' future results.**
- **This Document contains information about the performance of investments previously made by funds advised/managed by MV Credit. It does not purport to be a comprehensive or accurate view of future performance, targets or projections and whilst forward looking language may be used, this is only for illustrative purposes and not to be relied upon. Prospective investors must be aware that all investments in debt funds are speculative and involve substantial risk of loss. Please ask your professional advisor for advice regarding the specific risks.**
- Any statement as to risks herein is not an exhaustive list.
- This material has not been audited but is communicated in accordance with Article 14 (Investment Professionals), Article 21 (Certified high net worth individuals) and Article 22 (High net worth companies) of the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001, or pursuant to the permitted exemptions made available by the FCA in section 4.12 of its Conduct of Business Sourcebook and is not intended for retail clients (as defined in the FCA Rules) who should not, and cannot, rely on information here.
- This Document is issued to professional investors only such as financial institutions and other parties considering entering into business relationships with MV Credit and is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local laws or regulations. As such, the distribution of this Document in other jurisdictions may be restricted by law, and persons into whose possession this Document comes should inform themselves about, and observe, any such restrictions.

## Natixis Investment Managers' Additional Notes

This material has been provided for information purposes only to investment service providers or other Professional Clients, Qualified or Institutional Investors and, when required by local regulation, only at their written request. This material must not be used with Retail Investors.

To obtain a summary of investor rights in the official language of your jurisdiction, please consult the legal documentation section of the website ([im.natixis.com/intl/intl-fund-documents](http://im.natixis.com/intl/intl-fund-documents))

In the E.U.: Provided by Natixis Investment Managers International or one of its branch offices listed below. Natixis Investment Managers International is a portfolio management company authorized by the Autorité des Marchés Financiers (French Financial Markets Authority - AMF) under no. GP 90-009, and a public limited company (société anonyme) registered in the Paris Trade and Companies Register under no. 329 450 738. Registered office: 43 avenue Pierre Mendès France, 75013 Paris. Germany: Natixis Investment Managers International, Zweigniederlassung Deutschland (Registration number: HRB 129507): Senckenberganlage 21, 60325 Frankfurt am Main. Italy: Natixis Investment Managers International Succursale Italiana, Registered office: Via San Clemente 1, 20122 Milan, Italy. Netherlands: Natixis Investment Managers International, Netherlands (Registration number 000050438298). Registered office: Stadsplateau 7, 3521AZ Utrecht, the Netherlands. Spain: Natixis Investment Managers International S.A., Sucursal en España, Serrano n°90, 6th Floor, 28006 Madrid, Spain. Sweden: Natixis Investment Managers International, Nordics Filial (Registration number 516412-8372- Swedish Companies Registration Office). Registered office: Covendrum Stockholm City AB, Kungsgatan 9, 111 43 Stockholm, Box 2376, 103 18 Stockholm, Sweden. Or,

Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. Belgium: Natixis Investment Managers S.A., Belgian Branch, Gare Maritime, Rue Picard 7, Bte 100, 1000 Bruxelles, Belgium.

In Switzerland: Provided for information purposes only by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich.

In the British Isles: Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (FCA firm reference no. 190258) - registered office: Natixis Investment Managers UK Limited, Level 4, Cannon Bridge House, 25 Dowgate Hill, London, EC4R 2YA. When permitted, the distribution of this material is intended to be made to persons as described as follows: in the United Kingdom: this material is intended to be communicated to and/or directed at investment professionals and professional investors only; in Ireland: this material is intended to be communicated to and/or directed at professional investors only; in Guernsey: this material is intended to be communicated to and/or directed at only financial services providers which hold a license from the Guernsey Financial Services Commission; in Jersey: this material is intended to be communicated to and/or directed at professional investors only; in the Isle of Man: this material is intended to be communicated to and/or directed at only financial services providers which hold a license from the Isle of Man Financial Services Authority or insurers authorised under section 8 of the Insurance Act 2008.

In the DIFC: Provided in and from the DIFC financial district by Natixis Investment Managers Middle East (DIFC Branch) which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients or Market Counterparties as defined by the DFSA. No other Person should act upon this material. Registered office: Unit L10-02, Level 10, ICD Brookfield Place, DIFC, PO Box 506752, Dubai, United Arab Emirates

In Japan: Provided by Natixis Investment Managers Japan Co., Ltd. Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No.425. Content of Business: The Company conducts investment management business, investment advisory and agency business and Type II Financial Instruments Business as a Financial Instruments Business Operator.

In Taiwan: Provided by Natixis Investment Managers Securities Investment Consulting (Taipei) Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C. Registered address: 34F., No. 68, Sec. 5, Zhongxiao East Road, Xinyi Dist., Taipei City 11065, Taiwan (R.O.C.), license number 2020 FSC SICE No. 025, Tel. +886 2 8789 2788.

In Singapore: Provided by Natixis Investment Managers Singapore Limited (NIM Singapore) having office at 5 Shenton Way, #22-05/06, UIC Building, Singapore 068808 (Company Registration No. 199801044D) to distributors and qualified investors for information purpose only. NIM Singapore is regulated by the Monetary Authority of Singapore under a Capital Markets Services Licence to conduct fund management activities and is an exempt financial adviser. Mirova Division (Business Name Registration No.: 53431077W) and Ostrum Division (Business Name Registration No.: 53463468X) are part of NIM Singapore and are not separate legal entities. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.

In Hong Kong: Provided by Natixis Investment Managers Hong Kong Limited to professional investors for information purpose only.

In Australia: Provided by Natixis Investment Managers Australia Pty Limited (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only.

In New Zealand: This document is intended for the general information of New Zealand wholesale investors only and does not constitute financial advice. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. Natixis Investment Managers Australia Pty Limited is not a registered financial service provider in New Zealand.

In Colombia: Provided by Natixis Investment Managers International Oficina de Representación (Colombia) to professional clients for informational purposes only as permitted under Decree 2555 of 2010. Any products, services or investments referred to herein are rendered exclusively outside of Colombia. This material does not constitute a public offering in Colombia and is addressed to less than 100 specifically identified investors.

In Latin America: Provided by Natixis Investment Managers International.



In Uruguay: Provided by Natixis Investment Managers Uruguay S.A., a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay. Office: San Lucar 1491, Montevideo, Uruguay, CP 11500. The sale or offer of any units of a fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627.

In Mexico: Provided by Natixis IM Mexico, S. de R.L. de C.V., which is not a regulated financial entity, securities intermediary, or an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores) and is not registered with the Comisión Nacional Bancaria y de Valores (CNBV) or any other Mexican authority. Any products, services or investments referred to herein that require authorization or license are rendered exclusively outside of Mexico. While shares of certain ETFs may be listed in the Sistema Internacional de Cotizaciones (SIC), such listing does not represent a public offering of securities in Mexico, and therefore the accuracy of this information has not been confirmed by the CNBV. Natixis Investment Managers is an entity organized under the laws of France and is not authorized by or registered with the CNBV or any other Mexican authority. Any reference contained herein to "Investment Managers" is made to Natixis Investment Managers and/or any of its investment management subsidiaries, which are also not authorized by or registered with the CNBV or any other Mexican authority.

In Brazil: Provided to a specific identified investment professional for information purposes only by Natixis Investment Managers International. This communication cannot be distributed other than to the identified addressee. Further, this communication should not be construed as a public offer of any securities or any related financial instruments. Natixis Investment Managers International is a portfolio management company authorized by the Autorité des Marchés Financiers (French Financial Markets Authority - AMF) under no. GP 90-009, and a public limited company (société anonyme) registered in the Paris Trade and Companies Register under no. 329 450 738. Registered office: 43 avenue Pierre Mendès France, 75013 Paris.

The above referenced entities are business development units of Natixis Investment Managers, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Investment Managers conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorized. Their services and the products they manage are not available to all investors in all jurisdictions. It is the responsibility of each investment service provider to ensure that the offering or sale of fund shares or third party investment services to its clients complies with the relevant national law.

The provision of this material and/or reference to specific securities, sectors, or markets within this material does not constitute investment advice, or a recommendation or an offer to buy or to sell any security, or an offer of any regulated financial activity. Investors should consider the investment objectives, risks and expenses of any investment carefully before investing. The analyses, opinions, and certain of the investment themes and processes referenced herein represent the views of the portfolio manager(s) as of the date indicated. These, as well as the portfolio holdings and characteristics shown, are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material. The analyses and opinions expressed by external third parties are independent and does not necessarily reflect those of Natixis Investment Managers. Past performance information presented is not indicative of future performance.

Although Natixis Investment Managers believes the information provided in this material to be reliable, including that from third party sources, it does not guarantee the accuracy, adequacy, or completeness of such information. This material may not be distributed, published, or reproduced, in whole or in part.

All amounts shown are expressed in USD unless otherwise indicated.

Natixis Investment Managers may decide to terminate its marketing arrangements for this product in accordance with the relevant legislation