Private Debt Primer

A collection of MV Credit thought leadership pieces

April 2023

MARKETING COMMUNICATION

CONTENTS

Contents

Private Debt Market 4
Private Debt is Booming 4
Introduction 4
Robust asset class where experience matters 4
ESG aligned 5
Conclusion 6
Growth of Club Direct Lending 7
Decline of Distressed Debt Investor? 8
Key Highlights 8
Sourcing opportunities: Transfer restrictions 8
Sourcing opportunities: beyond documentation 9
Sourcing opportunities: finding a seller 9
Sourcing opportunities: alternative private debt 9
ESG considerations 10
Conclusion 10
Why does Private Credit Remain a Compelling Investment Opportunity vs High Yield Bonds in the Current Economic Environment? 11
Introduction 11
Return Considerations – Short Term Vs Long Term Returns Expectations 11
Return Considerations – Price 11
Return Considerations – Income 12
Risk Considerations - Interest Rate Risk 13
Risk Considerations - Opportunity Set 13
Risk Considerations – Recovery Rates 14
Conclusion 14
MV Credit - Illiquidity Premium 15
Down the Rabbit Hole: (Il) liquidity 15
Introduction 15
What is (Il) liquidity 15
The illiquidity premium in private markets 15
Investors and Liquidity 16
Conclusion 17
Markets: US vs Europe 18
Introduction 18
Bond Market Parallels and Company Size 18
Subordinated Debt 18
Bankruptcy Laws 18
Geography 19
Conclusion 19

Contents

CONTENTS

MV Credit: 20 Years of Fund Financing Expertise....20
Introduction and history....20
MV Credit's approach....20
MV Credit's fund financing guidelines....20
Fund financing market dynamics....21
Conclusion....21
Restructuring....22
Introduction....22
Uncertain times....22
The benefits of experience....22
Credit Selection is Critical....22
Taking stock: credit selection....22
Red flags to look out for....22
The proof is in the pudding....23
Partnering with the Right Sponsor....23
MV Credit investing over 20+ years....23
Why this strong track record?....23
A relationship-driven approach....24
Experience Matters....24
The consequences of borrower underperformance....24
Getting off to a strong start....24
Maintaining proactivity....24
Hard-earned experience....25
ESG....26
Evolution of ESG at MV Credit....26
Our Approach to ESG....26
Collaboration with EthiFinance....26
Investment Opportunities – Sustainability Linked Loans....27
Innovations in ESG....28
ESG-linked carried interest - KPIs tracked....28
KPIs tracked with bandings....29

Private Debt Market

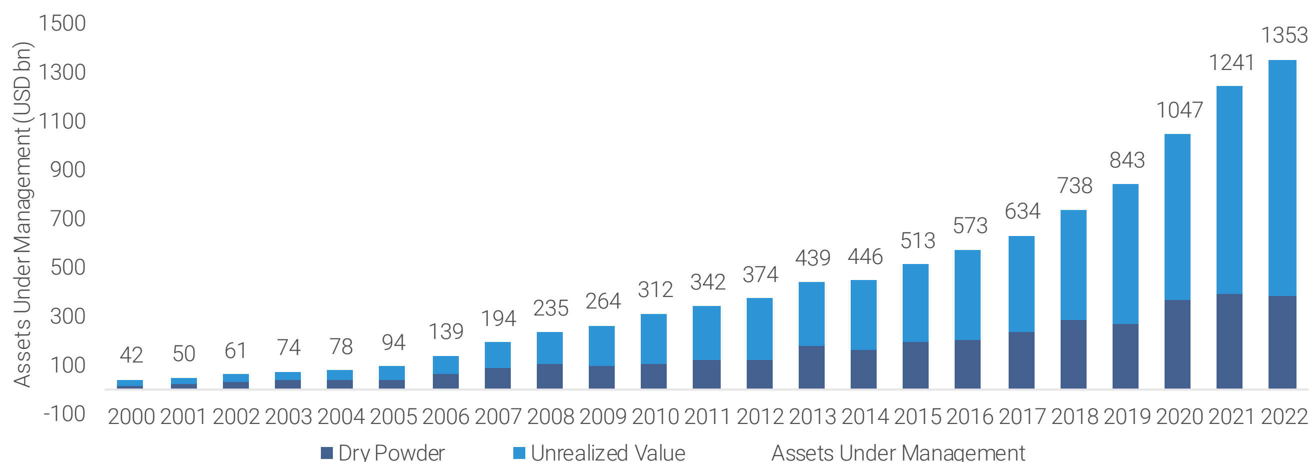
Private Debt is Booming

Introduction

The private debt landscape has changed significantly since the foundation of MV Credit back in 2000, transitioning from a niche asset class to a vital part of an asset owner's investment portfolio. In 2000, the senior debt market was dominated by investment banks, with funds offering more bespoke solutions typically within the subordinated debt space. Following the Great Financial Crisis ("GFC") the banks that were historically active retrenched, leading to the development of the private debt market as it is known today.

MV Credit has been active in the market since its infancy, and invested through multiple cycles, something that few managers can attest to. This experience in private debt is crucial when constructing a portfolio of defensive and robust assets. Private debt as an asset class has a multitude of benefits when an investor partners with the right manager. This piece aims to provide an insight into private corporate debt and the benefits it can bring within a diversified investment portfolio, alongside the growing push for ESG.

The Rise of Private Debt

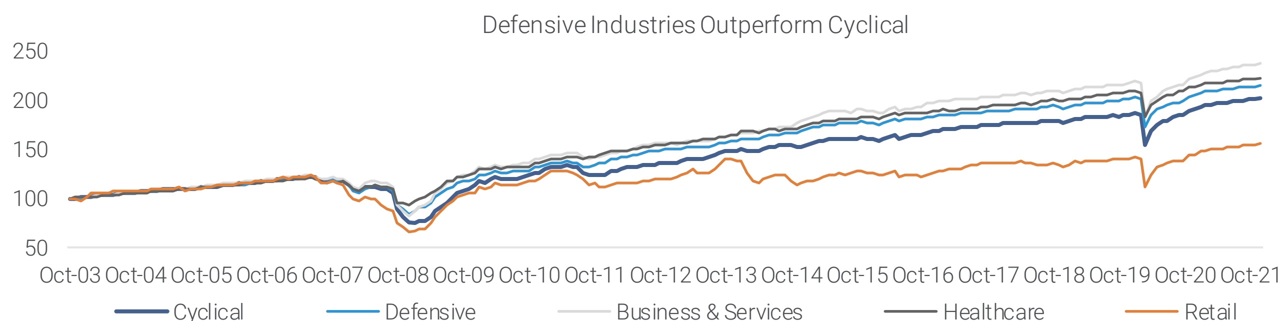


Source: Preqin, Dec 2000 – Jun 2022, Global Private Debt.

Robust asset class where experience matters

Consistent Risk-Return in Targeted Industries

The primary goal of a private debt manager is to generate consistent, stable returns whilst recovering the loan's principal. Outsized risks are typically not rewarded in this asset class due to limited upside. Therefore, it is key to invest in defensive and stable industries, such as healthcare and information services which offer stable and predictable cashflow generation and are hence better suited to sustaining economic shocks. Defensive industries have outperformed cyclical industries on a risk-adjusted basis by over 20%[1]



Source: LCD: October 2003 – December 2021.

[1] *Risk-adjusted basis calculated as the annualised return divided by the annualised volatility from October 2003 to December 2021. LCD.*

Private Debt Market *continued*

MV Credit has been investing in these defensive sectors for over 20 years and they currently represent over 50%[2] of the MV Credit investment portfolio. Ultimately, a debt manager's alpha stems from its ability to avoid defaults and minimise losses.

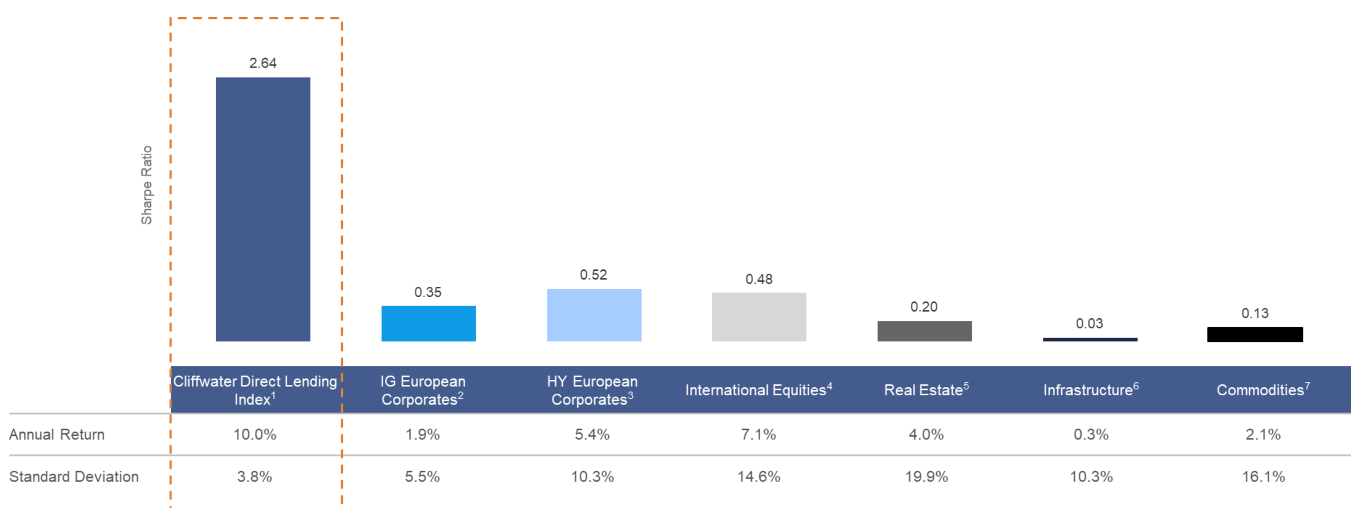
Interest Rate Protection

Prices are rising and assets owners are cautious while allocating capital to protect against rising rates. Investors are concerned over inflated equity valuations and the impact that higher interest rates will have on returns and performance. Private debt is 100% floating rate, providing a natural hedge against interest rates, with loans typically containing a floor limiting the impact of any unexpected drops in the base rate.

Meanwhile, MV Credit considers the impact of inflation when analysing each portfolio company and the ultimate flow through to costs (and the bottom line). This analysis is a key part of the stress testing of each potential investment. Private debt is not a flow business, and each transaction can be analysed in greater detail than the equivalent public market investment.

Cycle Resilient

The asset class has remained remarkably resilient through the cycle so far. It delivers stable returns with low volatility acting as safe harbour in times of crisis and has outperformed other asset classes.



	Cliffwater Direct Lending Index[1]	IG European Corporates[2]	HY European Corporates[3]	International Equities[4]	Real Estate[5]	Infrastructure[6]	Commodities[7]
Annual Return	10.0%	1.9%	5.4%	7.1%	4.0%	0.3%	2.1%
Standard Deviation	3.8%	5.5%	10.3%	14.6%	19.9%	10.3%	16.1%

Source: : LCD and Bloomberg market data as at 6th October 2022. Returns and Standard Deviation figures are calculated over the period January 2010 – October 2022. Returns for Cliffwater Direct Lending Index are calculated from 31st December 2009 – 30th June 2022 as the data is available quarterly. Bloomberg codes for the respective indices above are as follows: 1. BBG00JM29FP9, 2. BBG000S8RZX8, 3. BBG002SRWK41, 4. BBG000RKBX00, 5. BBG00DKNM2W4, 6. BBG001XVT251, 7. BBG00KLHZ3W4)

MV Credit has experience through multiple cycles including the GFC where its 2005 subordinated vintage returned a market beating 8.1%[3], demonstrating resilience through a downturn. Experience matters when investing in the market.

ESG aligned

ESG in private markets

During the past few years, ESG has firmly moved to the top of the agenda, as a drive for change has accelerated during the Covid-19 crisis. ESG has always been a topic of conversation for private debt managers who are seeking to avoid losses and protect against downside risks. 20 years ago, this meant avoiding certain industries which could face potential regulatory issues, such as oil and gas, tobacco and gambling.

This is now seen as the bare minimum as the outdated notion that private debt managers cannot impact ESG has changed, and ESG is now integrated at every stage of the due diligence process and ongoing monitoring. MV Credit has worked with a third party to develop a propriety scoring system, whereby each portfolio company is ranked on a scale. This tool has enabled engagement with the private equity owners of the businesses that MV Credit lends to.

[2] *Includes all MV Credit investments since inception as at 30th September 2022. Sector classification derived by MV Credit.*
[3] *MezzVest II realised net IRR.*

Private Debt Market *continued*

Investors are starting to realise there is more potential for impact within the private markets: where private equity sponsors own the entire company, vs. public market participants who only own a small piece. Private market investors typically have more control over their portfolio companies.

ESG linked loans.

A development MV Credit has been involved in is the growth of the Sustainability Linked Loan ("SLL"). The defining feature of the SLL is that the terms of the loan incentivise the borrower to improve the company's performance against certain pre-determined ESG criteria. This is then implemented via a ratchet mechanism on the margin, the typical adjustment being +/- 2.5-5bps. The structures of the loans have evolved from the use of standard third-party rating agencies to more bespoke KPIs. MV Credit will continue to offer SLLs across all its funds, in order to positively influence the behaviour of the underlying borrowers.

Diversity and Inclusion

It is important for private market participants to not only focus on their portfolio companies, but also to look within the firm at corporate practices.

In 2019, MV Credit realised a milestone achievement of reaching more than 50% total female employees. As at today, over 50% of the team and 39% of the senior team are made up of women[4]. In comparison, Preqin's 2022 "Women in Alternative Assets" Report found that 21% of all employees at private debt firms are female and that women represent less than 15% of senior positions[5]. Gender diversity has been built over years of commitment to equality across the team and this diversity aids in the investment decision making process.

MV Credit is proud to have been awarded the inaugural Diversity and Inclusion Leader of the Year-GP Mid-Market award at the 2021 Private Equity Awards and believes it is a trend setter in the space. The journey does not stop here as the team at MV Credit will continue to strive for best practice.

Conclusion

The private debt market has been resilient in times of crisis and provides an attractive opportunity to hedge against interest rise whilst delivering consistent returns. Experience is key and partnering with the right manager is paramount when investing in the asset class.

[4] *Source: MV Credit, as at 30th June 2022, based on the MV Credit team.*
[5] *Source: Preqin, Preqin Pro, "Women in Alternative Assets 2022", March 2022.*

Growth of Club Direct Lending

The private debt market has shifted dramatically since 2012 when the asset class truly started to flourish following the retrenchment of the banking sector. Along the way, multiple innovations and changes can have been observed. Following the dislocations in the markets due to the Covid-19 waves, the war in Ukraine and the risk of inflation fuelled by supply chain issues and energy price surges the direct lending market has evolved again to fill the gap historically addressed by the syndicated loan market in the upper mid-cap space. A key trend which has developed is that of the direct lending club deal where a handful of lenders come together to finance a company. Direct lenders are seeking to diversify exposure and reduce hold amounts across their portfolios whilst private equity sponsors are looking to diversify their sources of capital across multiple lenders. It is with this trend that we have prepared a short primer on the basics of club and sole direct lending, as well as any potential pros or cons.

	Club	Sole
Overview	This is where a small group of direct lenders (3-5) come together to club into a transaction to lend to a sponsored backed business ("collective lender"). This has typically been for larger businesses (>€50mn EBITDA).	This is where a direct lender invests and holds the entire tranche of debt and has historically been the case for smaller companies (<€30mn EBITDA). Given average leverage on an LBO of 5-7x, the transaction size could vary from €100 – 200mn of debt on the small end, and up to €500mn+ on a large or mid-market transaction.
Negotiating terms	Multiple lenders negotiating side by side on equal terms: • Pros: collective negotiating from multiple lenders can strengthen documentation. • Cons: process can be slower with multiple lenders.	One lender negotiating terms: • Pros: process can be quicker with one lender. • Cons: terms will still need to be on market for good credits, i.e., no "off market" terms.
Pricing	Depends on size, sector etc.	Same as club financing on a like for like basis
Capacity for entire tranche	Sponsors will often require some undrawn commitment along with the drawn commitment which can delay deployment. • Pros: not every lender will be required to invest in the undrawn commitment in a club transaction.	One sponsor will be required to invest in the entire tranche including the undrawn. • Pros: guaranteed full commitment if the lender wins the business - "all or nothing" • Cons: must invest in potentially capital inefficient tranches such as undrawn.
Control during a restructuring	Multiple lenders who in a restructuring can use collective engagement with the sponsor and are treated pari-passu: • Pros: multiple lenders have greater leverage in negotiations with private equity sponsors, whilst working in collaboration with each other. • Cons: potentially slower process with multiple lenders.	One lender to approve light amendments as well as working alone during a restructuring: • Pros: potentially more efficient for the borrower given one lender. • Cons: working alone without any participants to consult with can reduce bargaining power. Working alone can put pressure on internal resources.
Capacity for add-on financing	Multiple lenders in the club can be consulted for a potential add-on. • Pros: Multiple sources of financing for the sponsor and no pressure on any one lender to finance an add-on.	Sole must provide the add-on if required otherwise an additional lender must be found. • Pros: guaranteed follow on if required. • Cons: potential concentration issues and may not have capacity.
Liquidity	Potentially limited liquidity given club	No liquidity

Private Debt Market *continued*

Decline of Distressed Debt Investor?

Key Highlights

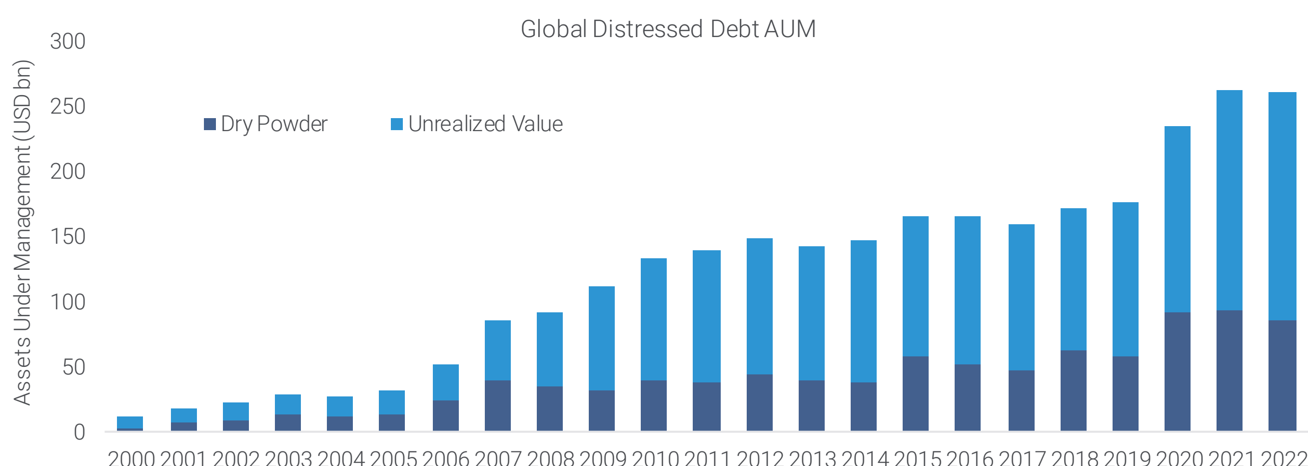
- Distressed debt investors may be locked out of deals due to restrictive documentation post 2008 resulting in limited deal flow
- Experienced private debt investors are seeing greater opportunities across the capital structure to deploy into creative and supportive solutions for performing credits
- Distressed debt has high return volatility and requires precise timing on when to invest resulting in uneven performance among managers
- Return streams more closely resemble private equity with uncertain cashflows and exit dates in comparison to the regular distributions typically associated with private debt
- Greater risk-adjusted returns can be achieved elsewhere given the right amount of investment flexibility within the private debt landscape
- ESG conscious LPs may be left conflicted with distressed investors methods when extracting value from failing companies

In times of an economic slowdown where businesses are fighting to stay alive, a distressed debt investor has a potentially fertile hunting ground. In light of this, we are frequently asked why we do not invest in distressed debt when the macroeconomic climate allows? We aim to highlight here a few issues which cause us to take a pause and reflect on what sort of private debt strategy is best placed to meet an investors expectations', even during a significant downturn in the economy.

Sourcing opportunities: Transfer restrictions

Put simply, a distressed debt investor aims to profit from buying debt at a deep discount (due to underperformance, default or even bankruptcy) from existing lenders who want out of the loan. Dry powder in distressed debt funds has been growing since 2008 and investors in the asset class have struggled to find places to deploy. Howard Marks, the co-founder of Oaktree Capital and renowned distressed-debt buyer was quoted as saying:

"Investing in distressed debt is a struggle today…. The economy is too good; the capital markets are too generous. It's hard for a company to get into trouble."



Source: Preqin (31/12/2000 – 30/06/2022)

Distressed debt investing relies on several factors such as a time of economic stress but also finding actionable opportunities. The ability for one lender to sell (or to "transfer"[6]) to another is essential in actioning an investment strategy based on buying other's positions. Post 2008 (and particularly in recent years), loan documentation has tightened and various restrictions[7] on transfers have been put in place:

[6] https://www.proskauer.com/alert/private-credit-considerations-for-debt-portfolio-acquisitions-in-times-of-uncertainty
[7] https://uk.reuters.com/article/sponsors-restrict-loan-sales-in-private-idUKL8N29E35W

Private Debt Market *continued*

Consent rights: if no event of default (typically now restricted to a bankruptcy or missed payment event) has occurred then transfer of the loan will require prior borrower consent. A private equity sponsor can therefore block such a transfer including to a distressed investor.

- **"Blacklists":** further restrictions can follow even after an event of default if a "blacklist" is in place which specifically prohibits a list or class of lenders (typically so called "vulture" or "loan to own" funds) in all circumstances from transfer of the loan, even after an event of default.
- **"Whitelists":** the same as the above but this is a list of pre-approved lenders to whom a transfer is acceptable. These generally only include par lenders.

The above restrictions have coincided with so called "cov-lite" loan documentation which sees financial loan covenants generally removed for term loan lenders. This has the added impact of delaying the threshold before a company falls into default (typically an actual payment default has to occur) as covenant breaches will no longer be triggered. This removes a significant amount of leverage available to distressed investors as they cannot bring the owner to the table and must work collaboratively with the other stakeholders to find a solution.

Sourcing opportunities: beyond documentation

When investment banks (specifically their distressed loan trading desks) are looking at ways to hold loans "on behalf" of distressed investors, the investment bank might "front" a secondary purchase for an investor. This process involves transferring the loan to an investment bank (i.e. the bank "fronts" the purchase) and then passing certain underlying rights of the loan to the distressed debt investor. Whilst this might be technically possible in some instances, we believe there are a number of potential challenges:

- For a bank to "front" the transaction they must be the lender of record which under current regulation requires them to use their balance sheet and hold capital against the loan. The bank can charge the distressed investor to do so but the reward for doing so is potentially unattractive for the capital it consumes. To compensate, a bank could charge the distressed investor higher fees but this creates higher costs for the distressed debt investor themselves.
- Distressed investing remains a niche asset class in comparison to traditional private debt and private equity. A universal bank could face reputational damage with its host of existing clients should it participate in such an arrangement and disrupt relationships elsewhere (e.g. within its substantial private debt and equity franchise).
- Borrowers, upon becoming aware of the arrangement, may seek to unwind the trade or challenge its structure. Documentation frequently seeks to block the movement of economic and contractual rights as well as transfers.

Sourcing opportunities: finding a seller

If a solution can be found around loan documentation, then an opportunity must be identified. We believe this differs from 2008 or any other crisis we have faced:

- The current economic crisis is largely a liquidity crisis (i.e. short-term funding needs over fundamental business failures). If the owner of a business (i.e. a private equity firm) is supportive and provides capital to see the company through, then the opportunity to invest into a distressed credit is eliminated (as the asset never becomes distressed).
- In addition, we believe that sponsors are better prepared and more socially conscious than in 2008, enhanced by an increasing focus on ESG. They also benefit from more flexible lending documentation. This is not a 2008 style crisis.
- Lenders are also better prepared. For example, existing lenders provide flexibility on covenants or interest payments (e.g. capitalisation of interest to PIK)

Whilst it is undoubtable that opportunities will exist, we believe that they will be limited in scale in comparison to previous economic downturns.

Sourcing opportunities: alternative private debt

Experienced private debt investors are seeing opportunities across the capital structure to deploy into creative solutions for performing credits during this period of economic uncertainty. For example:

- Support to companies with short term liquidity needs but otherwise stable credits.
- Bespoke financing to support the refinancing of strong performing credits at preferential terms given banks are stepping away from underwriting of second lien, in the context of increased volatility.

Private Debt Market *continued*

- Top up financing to support potential expansions as well as restructuring of frozen syndications which were not launched due to the COVID crisis.
- Acquiring performing credits on the secondary market that have depressed pricing due to the market and not fundamental valuations.

In addition to the above, we expect the following trends as private debt investors continue to deploy:

- The strongest credits will come to the market first, with cyclical assets having difficulty in sourcing financing (e.g. fashion retail, automotive etc.)
- Terms (legal, pricing etc.…) will be more lender-friendly while demand grows slowly after a period of economic stress (our experience post the GFC.

ESG considerations

While in certain instances, a distressed purchaser could open new options to borrowers in financial difficulty, we believe that strategies focused on "loan-to-own" or "short term profits" may create conflicts for ESG conscious LPs.

- It for example creates additional pressure and instability on management team and longer term "Par" stakeholders during restructuring processes.
- LPs in such strategy would also need to be comfortable with a higher exposure to weaker borrowers that would require significant operational restructurings in order to support a return to profit.
- ESG conscious LPs may be left conflicted with distressed investors methods when extracting value from failing companies

Conclusion

Economic uncertainty is what distressed debt investors thrive on, but uncertainty also surrounds their return profile and investment opportunity set given the climate and restrictive documentation. Other types of private debt can offer stable and outsized returns in these uncertain times. We believe that this crisis is fundamentally different to 2008 and that ESG conscious stakeholders will continue to support their companies through this difficult period, resulting in attractive long term returns for those involved and supportive, as well as simultaneously locking out potential distressed investors.

Private Debt Market *continued*

Why does Private Credit Remain a Compelling Investment Opportunity vs High Yield Bonds in the Current Economic Environment?

Introduction

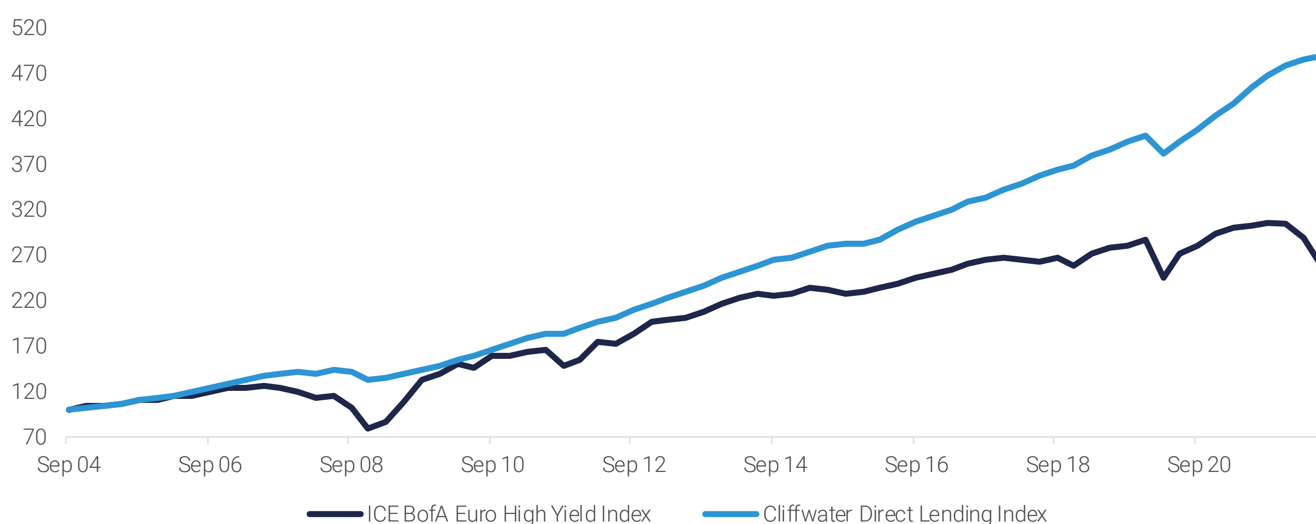
As the U.S and Europe transition into a new era of tighter monetary policy, higher interest rates have had dramatic consequences across virtually all asset classes. Bonds were amongst the hardest hit given the interest rate risk inherent with any fixed payment security. Bond prices have fallen to their lowest levels since the GFC, and as a result today's yields ("YTM") present opportunities for institutional investors. Some such investors now see High Yield Bonds ("HY") as directly comparable with Senior Private Credit ("PC") from a returns' perspective.

This short paper will examine the nuanced differences between these two asset classes from the perspectives of: return, risk, and geography/industry exposures; and present a case for why senior private credit remains an extremely attractive investment proposition. The ICE BofA Euro High Yield Index[8] has been used to represent the HY universe in the analysis below. PC is represented by both the S&P ELLI[9] and the Cliffwater Direct Lending Index[10] as appropriate (based on data availability).

Return Considerations – Short Term Vs Long Term Returns Expectations

The graph below shows that PC (as measured by the Cliffwater Direct Lending Index) outperforms HY by a significant margin on a non-risk-adjusted basis (total return of 389% vs 158%). Further analysis shows outperformance on a risk-adjusted basis too (Sharpe ratio of 2.51 vs 0.47).

1) Quarterly Index Returns (Sept '04 = 100)



Past performance is not a reliable indicator of future results.

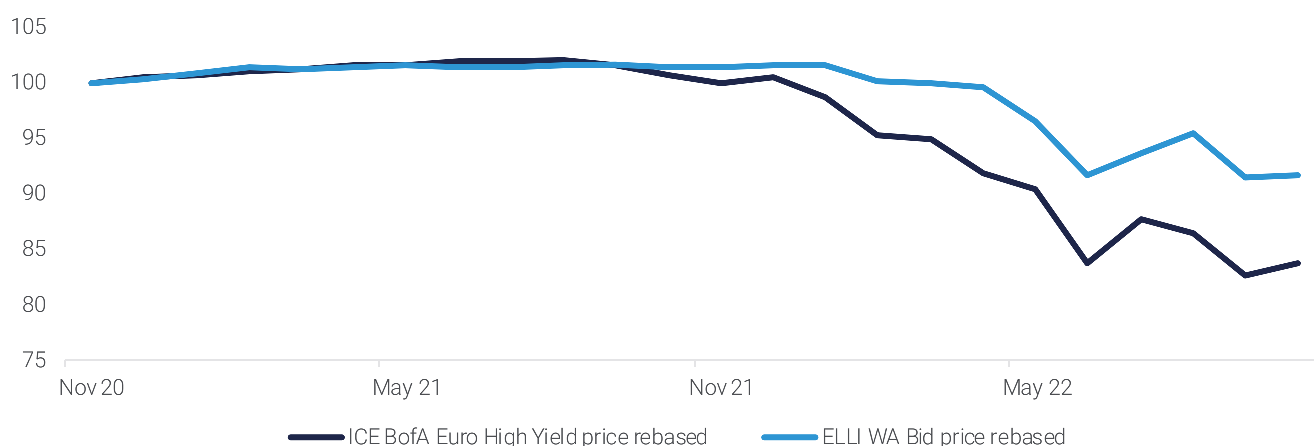
Although HY YTMs spike during some periods due to the inherent volatility of the asset class, PC displays consistent performance within the c.8%-10% range of annualised returns. Over the period shown, PC delivers 9.3% annualised return vs 5.5% for HY.

PC is an asset class that is proven to deliver consistent returns over long term time horizons, regardless of short-term market movements (as is made clear in graph 1). HY is an opportunistic prospect available exclusively in the short term where investors will have to hold for an undefined period to realise current yields. HY has underperformed significantly through the past 12 months, where PC has continued to deliver stable returns in the high single digits.

Return Considerations – Price

[8] Source: ICE BofA database: Nov 2022
[9] Source: https://www.lcdcomps.com/lcd/idx/index.html?rid=20 : Nov 2022
[10] Source: https://www.cliffwaterdirectlendingindex.com/ : Nov 2022

The graph below[11] shows the isolated price component of returns for the ICE BofA HY Index vs the S&P ELLI. The current interest rate environment has impacted HY with greater severity given the fixed rate nature of this asset class (please see "interest rate risk" section below). Current HY pricing presents an opportunity for new investors, but also serves as a warning that pricing can be volatile and is a significant contributor towards the long-run return underperformance vs PC demonstrated in graph 1) above.



Past performance is not a reliable indicator of future results.

The price decline through 2022 shows that this HY opportunity is only temporary. Before the shift in global interest rates, HY could not offer high single digit yields. The current yield is largely in place to compensate investors for increased interest rate risk (see below).

Return Considerations – Income

Contractual income returns (coupons/margin) are the second key component to consider when comparing the return profiles of HY and PC. The graph below[12] shows how the interest return component of the S&P ELLI compares with the income return component of the ICE BoA Euro HY index.

Past performance is not a reliable indicator of future results.

[11] *Source: ICE BofA database: Nov 2022 and https://www.lcdcomps.com/lcd/idx/index.html?rid=20 : Nov 2022*
[12] *Source: ICE BofA database: Nov 2022 and https://www.lcdcomps.com/lcd/idx/index.html?rid=20 : Nov 2022*

Private Debt Market *continued*

Income based returns across both HY and PC have responded positively to the macro-economic headwinds that have emerged through 2022 – **PC margins to a far greater extent, reaching 6.2% vs 4.2%** in Oct '22 as shown in graph 3).

PC margin increases since mid-2022 can be explained by a fall in the supply of loans to sponsor backed companies, with demand for these loans holding more steadily. Banks have stepped away from the market, becoming more hesitant to use their balance sheets for the arrangement and/or syndication of new deals. Hence, private equity sponsors are increasingly reliant on relationships with direct lenders and have been forced to accept wider pricing and more lender friendly terms.

Risk Considerations - Interest Rate Risk

Although both HY and PC asset classes display comparable return and credit risk profiles, the two investment opportunities are very different in the sense of their interest rate risk. Bonds are fixed rate instruments and hence are subject to price movements determined by the interest rate environment.

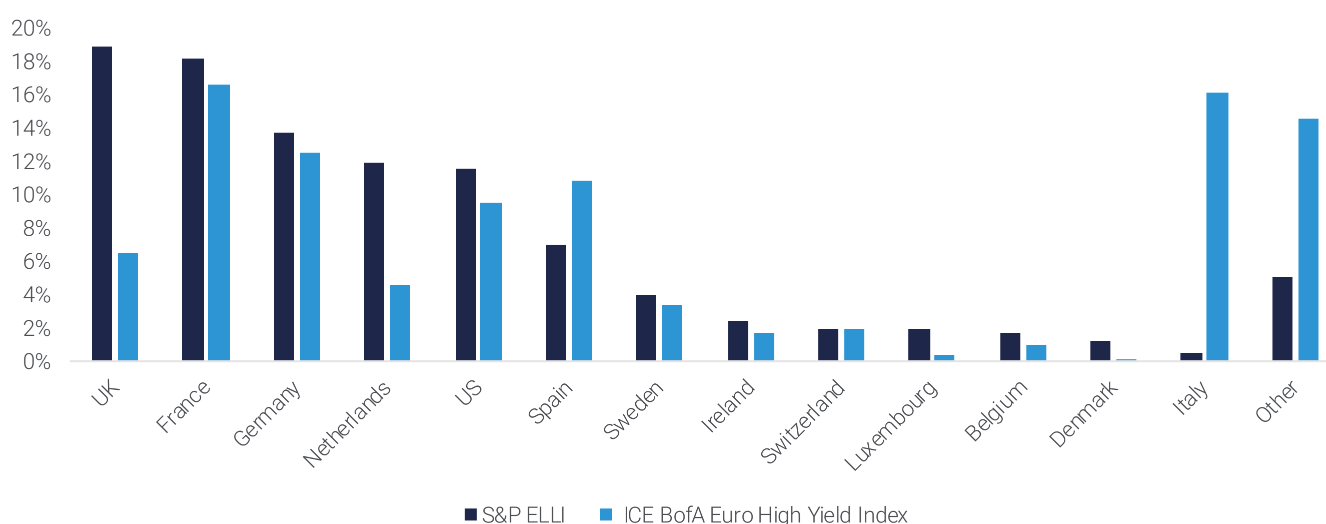
MV Credit invests in 100% floating rate instruments that have minimal duration, hence low interest rate risk. Any comparison between PC and HY should require HY bonds to include a premium to compensate investors for interest rate risk. Throughout the low and stable rate environment in Europe between 2013 and 2021, this risk was minimal. Today's ever-changing interest rate environment commands a higher premium. HY bonds currently do not offer investors a significant return premium above that of PCs, that come with a similar expected return and far lower interest rate risk.

Risk Considerations - Opportunity Set

Any investor wishing to make return comparisons between the PC and HY asset classes must also take the respective risks into consideration. Macroeconomic conditions across European countries can vary significantly, and there are substantially different risk profiles for businesses headquartered in developed Western European/Nordic countries vs Central/Eastern/Southern Europe. MV Credit invests predominantly in sponsor backed Western European businesses.

The graph below[13] demonstrates that the PC universe is concentrated more towards regions of lower geographic risk – UK, France, Germany, the Netherlands, US, Sweden, Ireland, Switzerland, Luxembourg, Belgium, and Denmark. The HY universe has a markedly large bias towards Italy (16%), with a larger allocation to "Other" European countries such as Bulgaria, Cyprus, Czechia, Estonia, Greece, Hungary, Lithuania, Poland, Romania, Slovenia, Turkey, and Ukraine.

MV Credit believes that the macro risks facing the less developed economies (which are more prevalent within the HY universe) are material and should command a return premium. Investors should be aware that these geographic risks are more pronounced within the HY universe relative to PC.

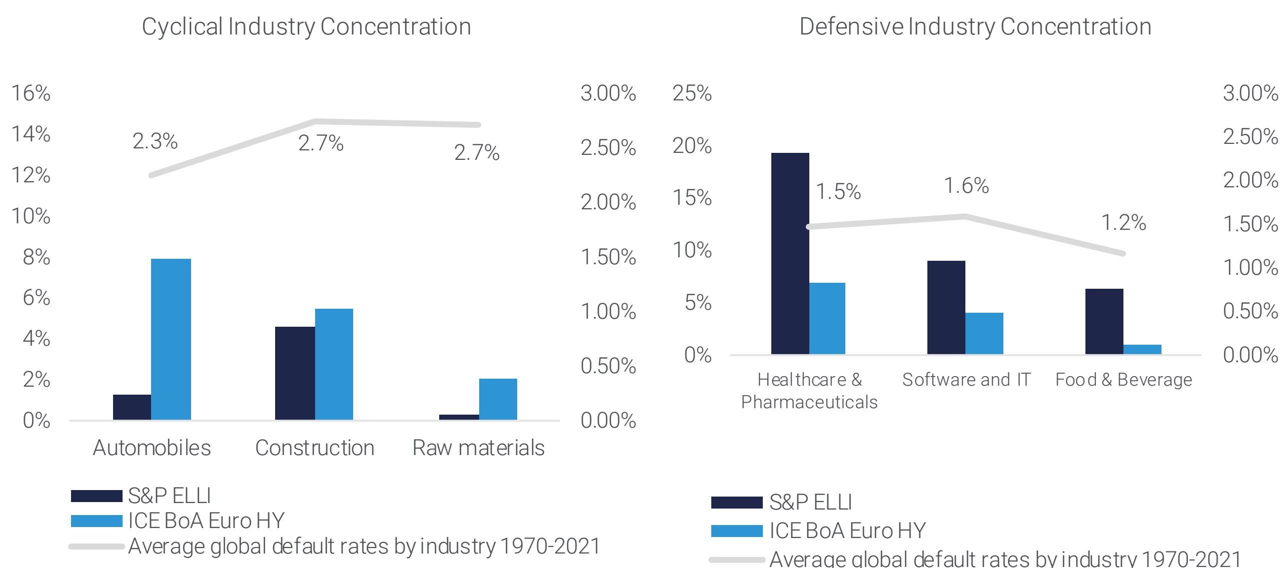


Past performance is not a reliable indicator of future results.

[13] *Source: ICE BofA database: Nov 2022 and https://www.lcdcomps.com/lcd/idx/index.html?rid=20 : Nov 2022*

Private Debt Market *continued*

This narrative is even more pronounced when one looks at industry exposure. The two asset classes are skewed very differently regarding concentrations in cyclical industries (such as automobiles, construction, and raw materials[14]) vs more defensive sectors (such as healthcare/pharmaceutical, software/IT and food/beverage[7]).



Past performance is not a reliable indicator of future results.

The graphs above illustrate the extent to which the HY universe is skewed more towards cyclical industries at the expense of the defensive industry allocation. These cyclical industries have significantly higher default rates[15] over a long-time horizon (1970-2021).

Risk Considerations – Recovery Rates

Downside risk is another area that potential PC and HY investors must consider when comparing the two asset classes. Loss (and hence return) expectations must be adjusted according to the recovery rates of past defaulting borrowers.

According to the 2021 Annual Default Study (Moody's): the volume-weighted average recovery rate for defaulted 1st Lien loans (secured) between 1983-2021 is 63.3% vs 45.2% for 1st Lien Bonds (secured and unsecured). Over the course of 2021, there were 13 1st Lien Loan defaults and the average recovery across these defaults was 68.8%. There were 38 Senior Bond defaults over the same period and the average recovery was lower at 52.9%.

Conclusion

Popular belief is that the HY asset class currently presents a compelling opportunity for investors seeking returns in the high single-digits.

A deep dive into several risk/return considerations reveals that - in MV Credit's opinion – the PC asset class continues to be a more compelling opportunity for investors over both the long and short term, even as bond prices remain depressed.

[14] *Industry buckets contain sub-industries across Moody's, S&P and ICE Bof A databases*
[15] *Source: Moody's annual default study 2021*

MV Credit – Illiquidity Premium

Down the Rabbit Hole: (Il) liquidity

This paper examines the "illiquidity premium" and how it is defined and quantified. As well as looking at how institutional investors have taken advantage of the additional yield, and how some are still not investing within the illiquid asset classes.

Introduction

The "illiquidity premium" has been a much-debated topic in economic theory for some time now, the premise being that if an asset cannot be readily sold without meaningfully impacting its value, then it should reward the holder with an enhanced return. A vast array of research has been conducted to try and quantify this figure, and yet (to our knowledge) a consensus does not yet exist. This paper aims to explore what it means for an asset to have (il)liquidity and the qualitative insights we have when assessing how this should be measured. This then warrants the question, how liquid are "liquid assets" really?

As we have seen in recent years, the race for yield is intense, and fundraising in private markets is booming. Perhaps now is the time to take advantage of the illiquidity premium?

What is (Il) liquidity

Liquidity is ultimately difficult (or impossible) to accurately measure and changes throughout time (generally lower in times of stress). A common definition involves defining a liquid asset as one that can be easily liquidated without having a material impact on the price that it can be sold for. For example, tighter bid-ask spread on bonds, typically implies higher liquidity. In benign economic periods it is relatively easy to intuitively distinguish between liquid and illiquid assets.

However, during times of economic stress even the most liquid assets can become illiquid. This was seen during the GFC 2007 – 2008 when interbank lending dried up and banks refused to trade. It is often during periods such as the GFC where investors want to get out the most that they cannot.

When the music stops, in terms of liquidity, things will be complicated." – Chuck Prince, Chairman and CEO Citigroup, June 24, 2007

Since the GFC and tighter regulations, banks cannot house proprietary trading desks, and therefore can only hold limited inventory of bonds which, reduces the level of liquidity in the financial system. It is arguable that liquidity has decreased since the GFC in 2008. Recently we have seen other funds offering "liquidity" be shone a light on, Woodford Patient Capital being a good example. Ultimately, we can define liquidity in a number of ways, but it is in times of stress that this matters the most.

"Only when the tide goes out do you discover who's been swimming naked." – Warren Buffett

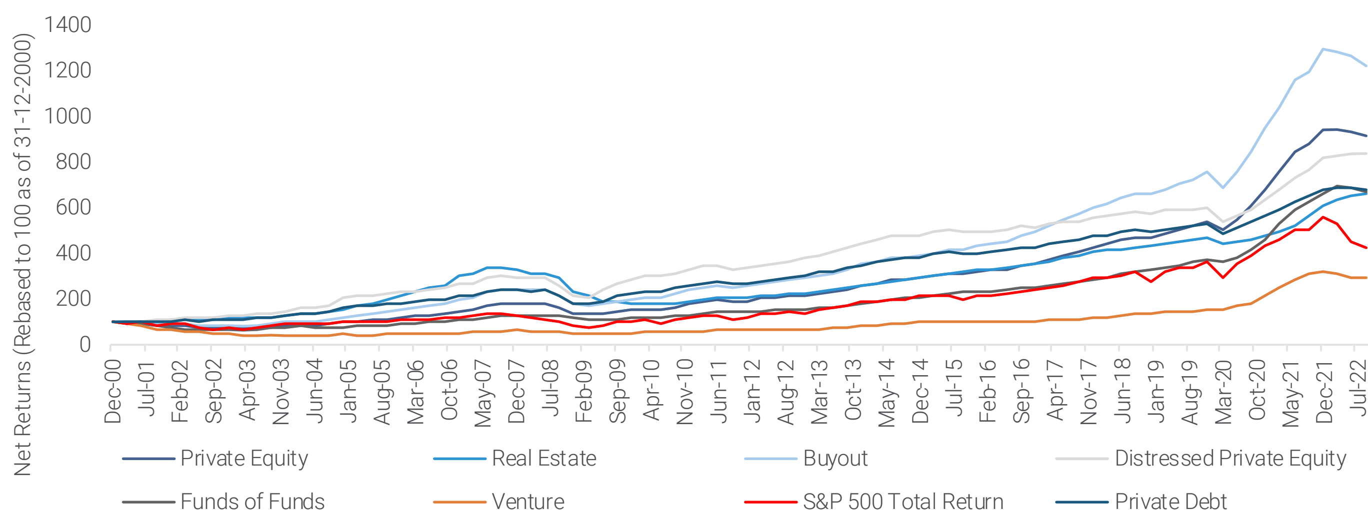
The illiquidity premium in private markets

Private markets have been outperforming public markets consistently since inception (see below for Preqin data on private vs. public market performance). These investments are typically structured as a GP-LP structure where the investor is locked in for the duration of the investment term, thus they are illiquid by definition. The above market returns are typically attributed to several factors:

- Most private transactions are often more complex and require a lot more structuring than their public market equivalents, resulting in potentially higher returns;
- Regulations restricting the ability of certain institutions to "fill up" on non-public investments;
- Private markets are inherently inefficient resulting in the opportunity to take advantage of this arbitrage;
- The illiquidity premium combined with the perceived additional risk of locking in your money for longer.

Private Debt Market *continued*

See below for the outperformance of private capital vs. their public market equivalent.



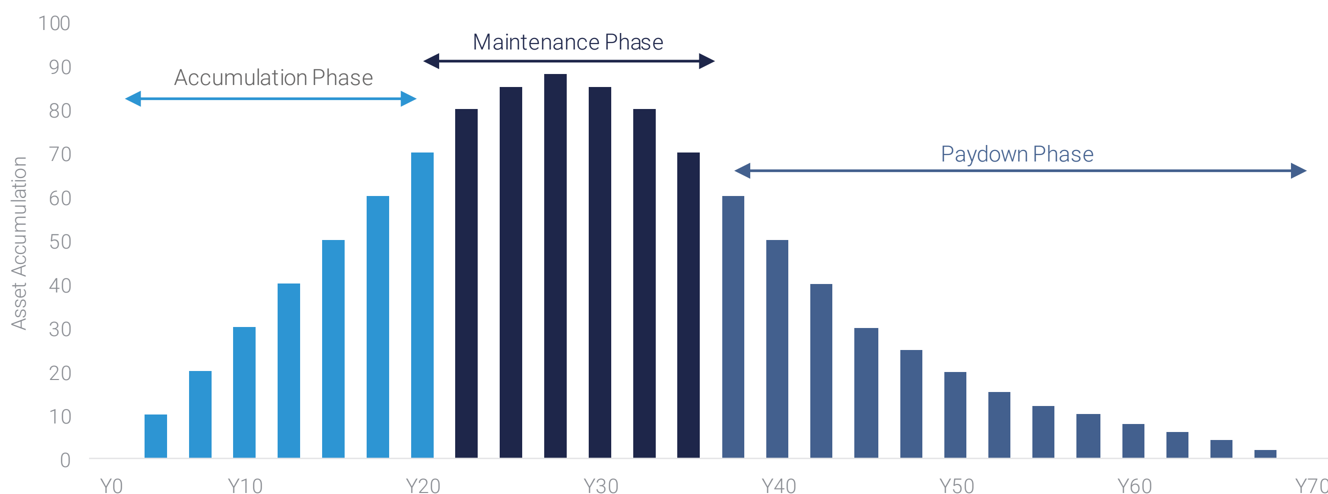
Source: Preqin (12/2000 – 08/2022)

It is hard to distinguish between the various components of private market returns. However, Willis Towers Watson's paper titled "Understanding and measuring the illiquidity risk premium" (March 2016) examined a framework for quantifying the illiquidity risk premium. It concluded that premium for private credit funds has declined from 373bps to 196bps in recent years. This is in line with the illiquidity premium tightening in benign periods.

Investors and Liquidity

Another group of investors who have benefited from the illiquidity premium due to their defined liabilities are defined benefit ("DB") pension schemes. DB schemes have predictable future cashflows, so being able to match their assets to their liabilities is highly valuable, leading to the growth of liability driven investing.

These DB schemes require very little free cash flow in their infancy, as it is only when they reach their later stages and people start to retire that they need to release capital. A lot of these schemes are in the later stages of their life but could still utilise the cash generation of a private debt fund. Please see below for the indicative life of a pension fund.



Source: MV Credit

Private Debt Market *continued*

As DB schemes start to tail off and are replaced by defined contribution ("DC") schemes, the need for long term investments becomes more relevant. These schemes are in their "accumulation" phase and have little need for liquidity. It is evident from the above that should an investor have a long-time horizon whereby they do not immediately need to release cash then the illiquidity premium can be taken advantage of. We expect DC schemes to rapidly adopt illiquid asset classes[16]. Many investors shy away from illiquidity, when in fact, it can be one of their most useful tools.

"Of the maxims of orthodox finance, none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of the investment institutions to concentrate their resources upon the holding of 'liquid' securities. It forgets that there is no such thing as liquidity of investment for the community as a whole" – John Maynard Keynes

Conclusion

Ultimately, the illiquidity premium is hard to quantify and even harder to isolate. This does not mean that it cannot be observed (as demonstrated by the insurance market and Solvency II as well as several academic papers) and we estimate it to be anywhere from 100-300bps. In addition, liquidity can be an illusion for those looking to exit an investment regardless of the underlying economic environment, whilst it potentially understates the risks an investor could be taking in an investment. Some investors already benefit from the illiquidity premium and others should follow. Investors with the ability and time horizon to allocate towards illiquid asset classes could earn significant upside.

"Invest for the long haul. Don't get too greedy and don't get too scared" – Shelby M.C. Davis

[16] *Investment Innovation and Future Consolidation: A Consultation on the Consideration of Illiquid Assets and the Development of Scale in Occupational Defined Contribution Schemes" Department for Work & Pensions. 02/2019.*

Private Debt Market *continued*

Markets: US vs Europe

Introduction

When plotted on the same chart, the S&P/LSTA US Leveraged Loan index and the S&P European Leveraged Loan Index ("ELLI") seem to track each other's movements over the peaks and troughs of the credit cycle. However, a closer look at the nuances of each market reveals a number of fundamental differences between the two. An understanding of these differences is critical for any investor looking prospectively at the two investment opportunities.

Bond Market Parallels and Company Size

The considerable differences between US and European High Yield ("HY") Bond Markets have implications for the respective Leveraged Loan Markets. The HY Bond and Leveraged Loan markets are considered close substitutes for one another; each providing capital to more highly levered companies outside of the Investment Grade space. **The US HY Bond Market exceeds Europe in terms of the size, number and variety of institutional investors.** As a result, the US HY market is more reliable, with larger issuers able to borrow throughout the credit cycle. In Europe, the HY Bond Market is less consistent and tends to "start and stop" with credit cycle peaks and troughs.

Consequently, most upper-mid/large sized US companies can rely on the HY Bond Market for financing and do not issue debt in the Leveraged Loan Market. **It follows that the typical size of issuers that utilise the US Leveraged Loan Market is lower than in Europe.** This has implications on the risk/return profile of the loans: The European market is better able to serve investors looking to invest in upper-mid/large sized companies.

Subordinated Debt

The term "Leveraged Loan" refers to debt across the capital structure - both senior and subordinated. **Differences in the terms, mechanics and usage of US and European loans are more pronounced when we compare the subordinated tranches.** US subordinated debt is typically issued for a range of reasons: corporate acquisitions, development capital and unsponsored transactions. **In Europe, subordinated debt is most frequently issued to fund PE sponsored transactions.** With regards to instrument mechanics, US subordinated Loans typically pay a fixed rate, while in Europe these loans pay a margin above LIBOR/EURIBOR that includes a floor. This structure eliminates any duration risk.

Furthermore, US subordinated loans generally contain more equity-like features than those found in Europe. In the US, equity warrants are often included allowing the holder to convert the debt to equity at a set strike price. This is rare in Europe.

The final structural difference is that subordinated European Leveraged Loans are typically secured against the underlying company which is not the case in the US. **Investors in Europe should benefit from having claim to the company's assets in an extreme downside scenario.**

	European Subordinated Debt	US Subordinated Debt
Fixed / Floating	Floating above floored EURIBOR / LIBOR	Fixed
Equity component	Rare	Common – warrants allow conversion to equity
Security	Secured	Unsecured
Transaction type	Funding of PE sponsored transactions	A wide variety: acquisitions, development capital, unsponsored transactions

Bankruptcy Laws

Insolvent companies in the US face a very different set of proceedings to similar companies in Europe. Chapter 11 bankruptcy laws allow the court to oversee restructuring proceedings while the firm continues to operate. The steps behind this process are well established and understood. All parties know the rules and enter proceedings with a dependable expectation of what the outcome will be.

A comparable European bankruptcy case will be much more complicated given there is no recognised set of rules and proceedings to follow. Businesses and their debt and equity holders are spread across different regions where bankruptcy laws vary and there is no set legal framework that guides the restructuring process.

Without no established set of rules in place, a successful outcome for a European company is often reached through collaboration between all parties involved. It is common for relationships between lenders and PE sponsors to play a part here. **This collaborative spirit is unique in Europe as all parties know it is the only way to reach a favoured outcome.** The result is that European investors tend to benefit from higher recovery rates than in the US.

Private Debt Market *continued*

Geography

The European Leveraged Loan Market is arguably more complex than that of the US. Europe contains a wider variety of political, economic and cultural institutions with some being more lender friendly than others. Upper-mid/large sized European businesses with multiple revenue streams tend to operate across multiple countries, with cash flows and supply chains extending across borders. Firms of a comparable size in the US tend to operate between different states but not outside of the US. The largest US companies that operate internationally tend to be served by international corporate bond markets.

The reasoning above indicates that risk factors associated with political or fiscal shocks are naturally more diversified within the European market. US Leveraged Loan risk factors include a concentrated exposure to shocks caused by US government policy.

Conclusion

Differences between the US and European Leveraged Loan markets are both pronounced and engrained given the permanence of factors discussed here. Structural differences between subordinated loans in the two regions are significant and should not be overlooked. Investors in the US can benefit from exposure to smaller companies with a larger equity component from their subordinated investments. Investors in the European market tend to benefit from: better access to companies in the upper-mid market; a collaborative approach to the restructuring process that often leads to higher recovery rates; and natural diversification against geopolitical risk factors.

MV Credit: 20 Years of Fund Financing Expertise

Introduction and history

Since inception, fund financing has been an important part of MV Credit's toolbox to deliver attractive risk adjusted returns. The aim of this paper is to illustrate the breadth of experience MV Credit has in using fund financing to create value for investors.

This value predominantly takes the form of:

- Utilisation of asset level leverage to generate enhanced risk-adjusted returns.
- Bridge financing for the purposes of LP liquidity and flexibility.
- Other innovative financing facilities to meet both short term and medium-term needs.

The expertise built up over the years allows MV Credit to offer investors tailored solutions with certainty of deliverability and attractive terms.

MV Credit has a specialist in-house team tasked with sourcing, structuring, and managing fund financing and maintaining institutional relationships.

MV Credit's approach

When sourcing and structuring fund financing, the MV Team utilises its deep relationships with a familiar network of lenders.

MV Credit funds target private equity backed Western European credits within non-cyclical, defensive industries such as subscription-based software services and healthcare. This focus on specific industries and geographies means that financing must be structured to ensure the lender's diversity/risk restrictions are met whilst maximising the borrower's investment flexibility.

MV Credit takes an active stance in structuring fund financing whilst working closely with lenders. The structuring is a collaborative and iterative process that ensures maximum flexibility for MV Credit. This approach is different to the "market norm", where terms are often taken by managers at face value without much participation in structuring or detailed analysis of the suitability of financing for the underlying funds.

The strength of MV Credit's relationships with lenders is attributable to their trust in our investment strategy. Trust is maintained via total transparency as well as MV Credit's ability to demonstrate performance with a long track record of success:

- Transparency - MV Credit has maintained healthy relationships with top tier investment banks that are based around transparency. MV Credit's policy is to ensure lenders are informed of all aspects of portfolio performance – good and bad. Any risk reports shared with investors are also circulated to lenders (they are ultimately an investor themselves). These discussions are key to building the lender's trust in MV Credit's ability to select performing credits and manage the fund financing.
- Track record – Evidence of MV Credit's strong track record is provided to new lenders in the early stages of the lender's due diligence process. This 20-year long record helps lenders validate the efficacy of MV Credit's investment process, allowing them to become comfortable and offer competitive terms

MV Credit's fund financing guidelines

MV Credit's experience structuring fund financing has manifested as a set of lessons learned that help shape MV Credit's negotiations with lenders today. As such, MV Credit retains a cautious approach to *1) mark-to-market covenants, 2) asset veto rights, 3) refinancing risk and 4) the ultimate utilisation of the facility:*

1) Avoiding a Mark-to-Market

MV Credit's core strategy in structuring fund financing is to avoid Mark to Market risk. The conventional lender proposition used by other managers is to mark portfolio assets to market. While this approach is understandable from the lender perspective, it means that the health of the facility is subject to external market movements. MV Credit's core strategy is centred around the principal of long-term buy-and-maintain investing. Hence, any covenant that re-values assets based on short-term market movements rather than the asset's long-term performance has the potential to upset the strategy's workings.

In the event of a market downturn where investors panic or are forced to sell, asset pricing often falls to a discount below the asset's true value. By structuring a facility so that assets are marked to market only in the event of poor performance, performing assets maintain their value over the course of a market shock. This approach to structuring prevents market shocks from upsetting the workings of the facility.

Private Debt Market *continued*

2) Asset Veto Rights

Credit selection is a key strength of the MV Credit Team. In structuring fund financing, the MV Credit Team ensures that the facility does not place any restriction on the origination capability of the fund. Vetoes are included in financing documentation by lenders to give them a say on how a portfolio is constructed. As such, each asset that the borrower intends to add to the portfolio must first be approved by the lender. MV Credit believes it is vital to maintain full control over the investment process and the ability to actively select credits.

3) Refinancing risk

Fund financing is structured so that the facility's life matches the fund's life as closely as possible in order to allow for the orderly amortisation of the portfolio to pay down the facility, thereby reducing refinancing risk.

Managers that execute short-dated facilities do so for increased flexibility and lower pricing, however these marginal benefits leave the manager vulnerable to a change in market standard terms as the refinancing date draws near. The post COVID-19 market environment highlights the dangers of this short-sighted approach.

4) Active and conservative approach

The negotiation of attractive terms and the flexibility that this enables is one of the key considerations during the structuring process. Pricing is an important factor, however subtle differences in aspects of the facility such as the loan-to-value ratio have significant implications for the usage of the facility. Securing a higher loan-to-value ratio allows for the potential to draw more capital from the facility, as each asset secures higher debt levels.

MV Credit's approach is not to draw on the facility aggressively, but to take a measured and conservative stance towards facility usage. The difference between possible facility usage and the actual utilisation can be thought of as a buffer. This buffer shelters MV Credit from the risk of an adverse scenario. MV Credit's work in collaborating with the lender to secure a high loan-to-value ratio generates value by increasing the size of this buffer.

Fund financing market dynamics

Having weathered numerous market cycles throughout the course of its history, MV Credit has witnessed how banks respond to adverse market conditions. Lending institutions are susceptible to staff turnover and the attitudes of risk teams and lending committees that can change very quickly in response to external shocks like COVID-19 or the Great Financial Crisis. In the current climate, banks are reining in their lending activity and renegotiating terms with borrowers whose portfolios are not performing. As a result, the portfolios of these borrowers suffer.

In stark contrast, since COVID-19 first rocked markets in March 2020, MV Credit has closed one bridge facility at pre COVID-19 pricing. The facility was negotiated over the course of Q1 2020 and was priced competitively relative to the pre-COVID-19 market. Despite the impact of COVID-19 upon the market over H1 2020, the lender did not seek to adjust pricing. This stance was attributable to the pre-existing relationship between MV Credit and the lender.

Furthermore, the MV Credit team is currently working to expand and enhance the MV Credit leverage program through the extension of a leverage facility currently in place with a senior fund of one. This is in stark contrast to the experience of other managers in the industry, who have had banks retreating from putting in new facilities or expanding existing ones

Conclusion

The above examples highlight the value-add of MV Credit's approach to working with lenders. MV Credit's attitudes to transparency and collaboration that help to form trusting relationships, mean lenders are less likely to adjust the lending terms of MV Credit facilities during times of stress. Furthermore, lenders have not been hesitant in their approach to doing new business with MV Credit. MV Credit offers investors the opportunity to invest in resilient credit portfolios with tailor made strategies to further enhance risk return metrics. Having successfully implemented various forms of fund financing over levered and unlevered strategies, MV Credit has the relationships necessary to secure attractive terms, as well as the expertise and experience necessary to use fund financing to create value for investors. These three elements are key to the success of MV Credit's strategy and can only be acquired through many years of investing in private debt markets.

Restructuring

Introduction

Uncertain times

A combination of events including continuing rising fuel prices, supply issues and labour market shortages following the pandemic, and the war in Ukraine has brought a significant amount of macro volatility and uncertainty. This current crisis, though different in cause and shape from the GFC of 2007/2008, may have a similarly negative economic impact and may result in an increase in the number of company defaults and restructurings not seen since then.

The benefits of experience

Whilst the current economic environment presents challenges for MV Credit, the firm has the advantage of 20+ years of experience in a market where only 11% of private debt managers in Europe have raised 6 or more funds[17]. Whilst the times ahead will likely pose challenges for all private debt managers, it may be more difficult for those with less investment experience, particularly in investing and managing portfolios during a downturn. The years following the GFC have presented an incredibly benign environment which has led to the establishment of lenders who have deployed in the longest bull market on record.

The recession negatively impacted a number of MV Credit's portfolio companies, with several requiring restructuring as a result. These restructurings took a variety of forms, with some realising positive returns and other assets making losses. In this section, MV Credit will explore the lessons learnt and experiences gained in its extensive history.

Credit Selection is Critical

Taking stock: credit selection

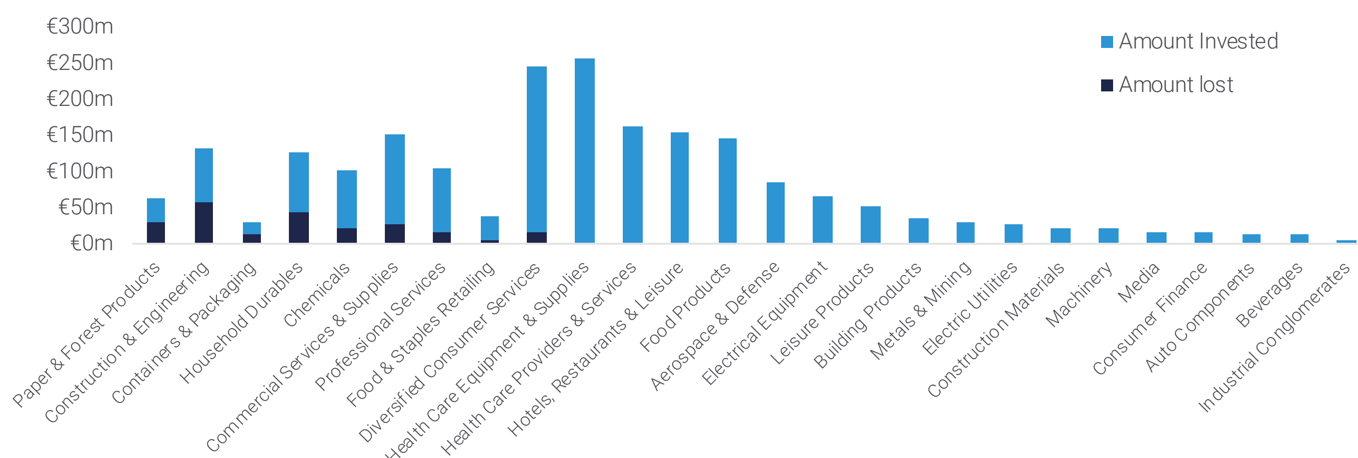
The importance of credit selection cannot be stressed enough. Looking back on the companies that required restructuring in MV Credit's 2006 vintage subordinated fund, their industry or credit characteristics often contributed to their underperformance. A key lesson learnt from this portfolio is that strict credit and industry selection can help mitigate the likelihood of a company underperforming and going on to realise a loss.

Red flags to look out for

- Looking back on that portfolio, industry-selection is critical when trying to avoid weak credits.
  - Some industries, such as household durables, are more correlated to economic cycles and cannot sustain the leveraged structures deployed by private equity sponsors in a downturn; some MV Credit portfolio companies in those industries suffered when the GFC hit.
  - For two portfolio companies in the paper and forest products industry, exposure to raw material price fluctuations contributed to their underperformance and losses were made on investments in both companies following financial restructurings. MV Credit is now very cautious towards companies in industries that rely on raw commodity prices.
- The credit fundamentals of a potential borrower are also crucial considerations. Some MV Credit portfolio companies that suffered during the GFC were negatively impacted by high fixed costs or because they were capex intensive. These businesses do not have the flexibility to reduce costs when revenues are hit.
- Other companies have business models which make them less suitable to being levered, such as one project related portfolio company (this company underperformed and was restructured, with MV Credit's investment eventually realising a positive return). Another borrower, which MV Credit exited in anticipation of a third restructuring, taught MV Credit to be cautious of companies that relied on bonding lines. This company had remained cash-rich, but its cash came from clients' down payments which could not be used to service debt. This business model helped contribute to the company's financial woes.

[17] *Source: 2020 Preqin Global Private Debt Report. Proportion of active private debt fund managers in Europe who have raised 6 or more funds, source: Preqin Pro, 1st June 2020.*

Restructuring *continued*



Source: MV Credit, data period between 2000-2022. The Industries shown are those through which MV Credit's subordinated fund invested. Losses and defaults refer to losses experienced by MV Credit funds. Industry classifications are defined by MV Credit. Losses are defined as realised investments which achieved TVPI of less than 1x, calculated as total distributed minus total invested. Past performance is not indicative of future results and there can be no assurance that any historical trends will continue.

The proof is in the pudding

"The four most dangerous words in investing are: this time it's different" – Sir John Templeton.

The Deal Team at MV Credit has continued to originate deals with the lessons of the GFC in mind, exercising caution towards certain industries and avoiding companies with weak credit fundamentals.

MV Credit's investment focus is now firmly targeted towards defensive industries such as healthcare providers and services and software, an approach that has secured attractive risk-adjusted returns in the past. Since the GFC, MV Credit has not made a loss or experienced a default on a company in the information technology or health care sectors, which make up a significant portion of MV Credit's investment strategy.

Partnering with the Right Sponsor

MV Credit investing over 20+ years

Over 20+ years, MV Credit has partnered with over 80 sponsors across its subordinated and senior platforms, navigating multiple credit cycles. Looking back, MV Credit has lost little or no money with the majority of sponsors it has partnered with, having found them largely proactive and supportive of borrower companies in instances of underperformance. Of these 80 sponsors, MV Credit has only experienced losses with 16, whilst of these 16, 13 had substantial losses (more than 50% loss rate)[18]. As a result, MV Credit would be wary working with these sponsors again.

Why this strong track record?

MV Credit believes that partnering with the right sponsor is a key factor behind this strong track record. Over more than 20 years, MV Credit has built up an invaluable insight into what makes the "right" private equity sponsor and how partnering with them can help minimise the impact of credit losses (the ultimate driver of returns in debt investing):

- The "right" sponsor should be relied on to manage borrower companies effectively. A good manager should be able to execute the initial investment strategy (by growing the business) and proactively address any unexpected problems that may arise. Sponsors' management can be a factor in what goes wrong for a borrower company, for example if they have a lack of direction (as a result of not following through with the initial thesis) for a company or if they are less proactive in addressing issues early on.
- The sponsor should act fast to make changes to a borrower company in times of stress or underperformance.

[18] *Source: MV Credit, as at 30th September 2022. Data period 2000 - 2022 across MV Credit's subordinated and senior platforms. Number of sponsors includes consortiums and multiple sponsors working together. Losses are defined as realised investments which achieved TVPI of less than 1x, calculated as total distributed minus total invested. Loss rate is total lost as a percentage of total invested per sponsor. Losses as a percentage of total invested refers to total lost across these 6 sponsors as a percentage of total invested across all sponsors. Past performance is not indicative of future results and there can be no assurance that any historical trends will continue.*

Restructuring *continued*

- The best sponsors will be supportive in times of stress for a company, as MV Credit saw during the GFC. Some sponsors supported underperforming businesses by injecting equity, not taking dividends and even completing debt buy-backs to reduce borrower companies' leverage. In comparison, some sponsors proved to be less supportive of underperforming businesses and abandoned them all together, which ultimately led to MV Credit realising a loss on its investment.
- The "right" sponsor will be aligned with MV Credit's ESG values and can be trusted to adopt best practices whilst managing borrower companies.

A relationship-driven approach

Based on experience, MV Credit has built up relationships with the "right" private equity sponsors. These relationships, consolidated and institutionalised over more than 20 years, are a crucial part of MV Credit's investment strategy:

- Private equity sponsors are a key source of origination for strong credits. MV Credit is often the first or second call when its relationship sponsors are seeking a menu of financing options.
- As one of just a few managers who can lend across the capital structure, MV Credit can often negotiate strong reporting packages through its sponsor relationships (typically for the subordinated tranches), so it can monitor investments on an ongoing and stringent basis. Active monitoring is key to ensuring that MV Credit can detect and respond to any signs of underperformance early.
- During the GFC there were cases where an underperforming company's sponsor, with whom MV Credit had a relationship, approached MV Credit at an early stage to discuss a potential restructuring. This enabled MV Credit to prepare for a restructuring process and engage early with the sponsor in trying to find a potential solution that resulted in a preferred outcome for all parties involved.
- Should a company require restructuring, an institutional relationship between MV Credit and the sponsor (as well as other lenders) can help facilitate an outcome and is beneficial during negotiations. Ultimately, it is about working collaboratively with (and not against) the sponsor in times of stress and a "good" relationship should return the same.

Experience Matters

The consequences of borrower underperformance

Despite stringent credit selection and partnering with supportive private equity sponsors, some private debt portfolio companies underperform expectations, particularly during a downturn. This can result in restructurings.

For an investor targeting performing credits, restructurings are certainly not ideal. Restructurings can change the terms of the original loan agreement in a number of ways including altering debt pricing, extending the debt's legal maturity, altering the capital structure with a new money injection, swapping debt for equity, or even writing off a loan entirely.

Getting off to a strong start

Since inception in 2000, MV Credit has been involved in a few restructuring scenarios, most of which date back to the GFC. Whilst the restructurings had different circumstances and involved a range of key players; experience demonstrated the ways in which a private debt investor can seek to safeguard its investment and enter a restructuring on a solid footing:

- **Identify problems early**. An astute investor is always on the lookout for early signs of underperformance, regardless of the economic environment. Waiting for covenant breaches to indicate a company's deteriorating performance will delay action resulting in the loss of valuable time. MV Credit adopts an approach of "healthy paranoia" towards all its portfolio companies and its monitoring processes aim to pick up on early warning signals of underperformance. A key part of this is its independent Credit Monitoring Team, which systematically monitors each portfolio company alongside the Deal Team, using proprietary non covenant based financial ratios.
- If there are signs of underperformance, it's essential to **start discussions early**, even informally. MV Credit is proactive in reaching out to private equity sponsors when it detects underperformance. Gaining a sense of the sponsor's next steps is crucial to assessing the future of a company and the likelihood of a turnaround.

Maintaining proactivity

Once in a restructuring scenario, MV Credit advice to lenders would be to:

Restructuring *continued*

- Aim for a consensual solution and maintain dialogue. MV Credit seeks to resolve restructurings through a consensual, out-of-court approach, with an agreement typically based on full consent by the debt lenders, or a majority of lenders. MV Credit is generally reluctant to pursue legal enforcement during a restructuring and believes that working collaboratively is usually the best way to minimise credit losses and ensure that trustworthy relationships are maintained.
    - Only one of MV Credit's historical restructurings was ultimately non-consensual, with MV Credit challenging a UK scheme of arrangement.
    - Other investors, such as distressed lenders, can be obstacles to co-operation. In a few instances during the GFC, distressed debt funds challenged MV Credit's position whilst seeking an opportunistic profit. However, future restructurings may see distressed lenders pose fewer challenges; with private equity sponsors seeking to protect their portfolio companies with restrictions on transfers[19] and potentially looking to use cov-lite documentation to resist attempts to seize control of their investments[20].
- Be active in negotiations. During the GFC, MV Credit frequently adopted a leadership role in restructurings, often playing an important role in formal or informal "Steering Committees", which are led by a group of elected lenders. For example, MV Credit played key roles including coordinating the Mezzanine response as one of the main Mezzanine lenders and representing Mezzanine lenders during negotiations. This gave the firm leverage and a greater platform to put across its views and interests.

Hard-earned experience

Given the current economic turbulence, investors are focusing a lot of effort towards monitoring their existing portfolios. However, some newer players may be limited by a lack of restructuring experience. MV Credit has gained this experience since its inception in 2000 and puts the lessons learnt at the forefront of its investing. MV Credit's supportive conduct during past restructurings and its excellent relationship with private equity sponsors help provide goodwill and certainty should a restructuring arise. Crucially, most of the senior members of MV Credit joined the firm prior to the GFC, and this experienced team can provide invaluable leadership and experience during the potentially turbulent times ahead.

[19] *Source: Laura Benitez, Sarah Husband, and Ruth McGavin, "PE Firms Race to Block The Exits to Ward Off Vulture Funds", Bloomberg.*

[20] *Source: Robin Wigglesworth and Sujeet Indap, "Distressed debt investors still await rich pickings from pandemic", The Financial Times, Accessed 2nd November 2020.*

ESG

Evolution of ESG at MV Credit

Our Approach to ESG

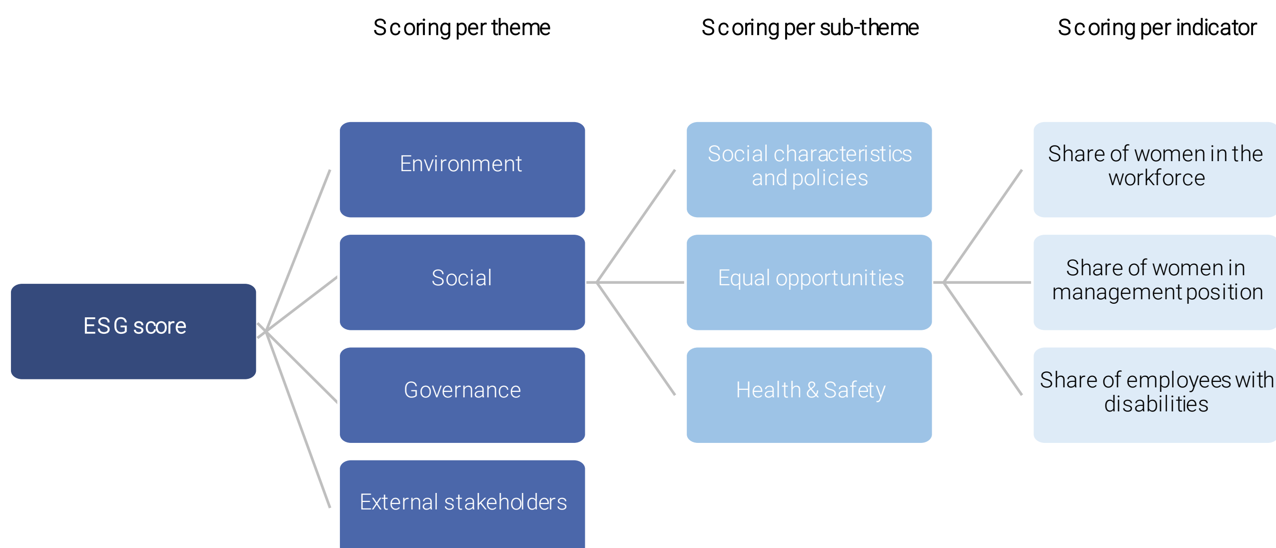
MV Credit strives to be practical, progressive and aspirational in its approach to ESG. We focus on three core themes in our implementation of ESG at the firm level:

1. Corporate Social Responsibility
    - Charitable works and volunteering.
    - Focus on diversity & inclusion.
    - Corporate sustainability e.g. firm carbon offsetting.
2. Integration of ESG considerations into the investment process
3. Reporting, transparency and promotion of ESG
    - Collaboration with peers on industry initiatives.
    - Working with EthiFinance to improve ESG reporting to our investors.

Collaboration with EthiFinance

In March 2021, we released our inaugural annual ESG report to our investors, which is a result of our collaborating with EthiFinance. EthiFinance is a European leader in the ESG assessment of SMEs, based in France.

4. The Framework
    - Singular ESG framework built with EthiFinance comprising over 55 KPIs. This has been updated to incorporate mandatory Principal Adverse Impacts as required by the Sustainable Finance Disclosure Directive.
    - KPIs are thematic based on theme, sub-themes and indicators.



5. The Methodology
    - Collective scoring of the underlying portfolio companies leads to a Star System for the fund as a whole (rated out of 5).

ESG *continued*

ESG rating levels of the fund

Introduction (0-20 / 100)

Progression (20-40 / 100)

Intermediary (40-60 / 100)

Advanced (60-80 / 100)

Excellence (80-100 / 100)

6. The Outcome – MV Senior II 2021 Data Collection

- For the 2021 data collection campaign, the average score for MV Senior II portfolio companies was 62 out of 100 – a 4-star rating.
- Average response rate from borrower companies of 94.7% for all KPIs.

We believe by creating transparency and measuring progress, we can foster management teams to assess how they stack up against ESG-related issues, and how they can improve in the future. We see this is an important initiative to drive change in the industry.

Investment Opportunities – Sustainability Linked Loans

What Are Sustainability Linked Loans?

The defining feature of sustainability linked loans is that the terms of the loan incentivise the borrower to improve its performance against certain pre-determined ESG criteria. This is implemented via a ratchet mechanism on the margin, with the typical adjustment being + / - 2.5 -5bps.

The Market

Against a backdrop of increasing awareness of ESG and climate change risks, the last two years have seen a dramatic increase in the issuance of sustainability linked loans. After initially being focused on sectors such as Real Estate and Utilities, market growth is now becoming more prevalent within other sectors including Consumer, Industrials and more recently Financial Services. The structures of the loans have evolved from the use of standard third-party rating agencies, to more bespoke KPIs. Furthermore, KPIs have evolved from being predominantly focused on Environment, to a broader range of Social and Governance-related goals as well.

The Mechanism

The ratchet mechanism is a way for lenders to reward (or penalise) a borrower's incremental positive (or negative) changes they are making with regards to various KPIs. Where traditionally these KPIs have related to financial characteristics such as de-leveraging, this mechanism is now being utilised towards the measurement of ESG KPIs.

For the borrower, there is a monetary benefit from meeting these ESG KPIs through a nominal reduction in the overall coupon paid on its loans. For the lender, there is a nominal reduction in the coupon to ensure that the borrower is incentivised to adhere to the agreed standards and targets. In case of the existence of penalties for not meeting these agreed KPIs, the reverse is true.

The increasing issuance of sustainability – linked loans presents an opportunity for MV Credit funds to invest in a responsible manner.

Innovations in ESG

During the past two years, ESG has firmly moved to the top of the agenda, as a drive for change accelerated during the Covid-19 crisis and is only gaining further momentum. ESG has always been a topic of conversation for private debt managers who are seeking to avoid losses and protect against downside risks. 20 years ago, this meant avoiding certain industries which could face potential regulatory issues, such as oil and gas, tobacco and gambling.

This is now seen as the bare minimum as the outdated notion that private debt managers cannot impact ESG has changed, and ESG is now integrated at every stage of the due diligence process and ongoing monitoring. MV Credit has worked with a third party to develop a propriety scoring system, whereby each portfolio company is ranked on a scale. This tool has enabled engagement with the private equity owners of the businesses that MV Credit lends to.

Following this development, the team at MV Credit are seeking to lead the way in aligning stakeholders in the management of the fund. To further its commitment to ESG, MV Senior III will have carried interest with ESG-linked features. This is in addition to a bridge facility which will use the same KPIs within a potential margin ratchet.

ESG-linked carried interest - KPIs tracked

The KPIs utilised are common between the carried interest and the bridge financing and focus on areas raised as concerns by investors globally for our asset class:

KPI 1: Percentage of Senior Women at MV Credit:

- This KPI will assess representation of women at the senior level against a benchmark far above that of the industry. MV Credit has researched the market average for private debt, which is estimated at 10.9% by Preqin (Mar'21). MV Credit sees itself as a market leader in diversity and inclusion and this will further strengthen its commitment
- MV Credit is committed to ensuring an inclusive workforce, and this requires a continuous effort to recruit and retain diversity at all levels of the organisation and therefore this KPI remains static

KPI 2: Overall Fund ESG Questionnaire Response Rate:

- This KPI measures whether portfolio companies respond to the MV Credit annual ESG questionnaire. This KPI will incentivise MV Credit to enhance engagement and transparency with its portfolio companies as a lender. This information will strengthen the credit analysis conducted on each portfolio company.
- The principal objective is to monitor and measure progress as a responsible investor, ensuring continuous advancement. Therefore, the response rates are key to ensure sufficient information to properly assess a company's ESG standing.
- Increasing response rates requires proactive engagement with companies on the topic of ESG, particularly companies with lower response rates. Therefore, the focus on increasing response rates helps to promote best practices and drive wider discussions on ESG with clients in different industries.

KPI 3: Overall Fund ESG Score:

- This KPI assesses the overall ESG score of the MV Senior III portfolio. This KPI will exclude any portfolio companies that had a low response rate, given that response rate is being assessed by KPI 2. This fund score will be determined in collaboration with a third party ESG specialist, currently EthiFinance. The score incorporates over 50 KPIs linked to each component of ESG.
- The score is a good overall indication of the fund's ESG performance and will be used as a key measure to track progress. The ESG score in addition to the response rates will help us identify the actions needed to increase the ESG performance across each of our investments
- The ESG framework is made up of indicators that are categorised into themes and sub-themes. These indicators are scored against a comparison group benchmark (based on EthiFinance database of c.500 European companies), ensuring the score reflects ESG performance in the context of the broader market.

Example Calculation (assuming 10% carried interest)

A carry ESG score will be determined annually for each of the three investment period years. In each year there is a total of 6 points available, over three years the total points available will be 18. The carry percentage will be calculated as the total carry score awarded, divided by the total carry score available, multiplied by 5% (50% of total carry). For example, if 15/18 KPIs have been met over the investment period, this is a success rate of 83%. Therefore, the total carry payable to MV Credit will be 5% + 5% * 83% = 9.17% of the profits due once the performance hurdle has been met.

The financing cost on the bridge facility will be adjusted depending on the relevant score achieved – please see below for ratchets.

ESG *continued*

KPIs tracked with bandings

KPI 1	% Senior Woman at MV		
Target	<= 25%	25% < x < 40%	>= 40%
Margin Impact	(+) 2.0bps	No Change	(-) 2.0bps
Carry Score	0	1	2

KPI 2 (YR 1)	Overall Fund ESG questionnaire Response Rate		
Target	<= 40%	40% < x < 70%	>= 70%
Margin Impact	(+) 1.0bps	No Change	(-) 1.0bps
Carry Score	0	1	2

KPI 2 (YR 2)	Overall Fund ESG questionnaire Response Rate		
Target	<= 45%	45% < x < 75%	>= 75%
Margin Impact	(+) 1.0bps	No Change	(-) 1.0bps
Carry Score	0	1	2

KPI 2 (YR 3)	Overall Fund ESG questionnaire Response Rate		
Target	<= 50%	50% < x < 80%	>= 80%
Margin Impact	(+) 1.0bps	No Change	(-) 1.0bps
Carry Score	0	1	2

ESG *continued*

KPI 3 (YR 1)	Overall Score (Excluding Low Response Rate)		
Target	<= 40	40 < x < 60	>= 60
Margin Impact	(+) 2.0bps	No Change	(-) 2.0bps
Carry Score	0	1	2

KPI 3 (YR 2)	Overall Score (Excluding Low Response Rate)		
Target	<= 45	45 < x < 65	>= 65
Margin Impact	(+) 2.0bps	No Change	(-) 2.0bps
Carry Score	0	1	2

KPI 3 (YR 3)	Overall Score (Excluding Low Response Rate)		
Target	<= 50	50 < x < 70	>= 70
Margin Impact	(+) 2.0bps	No Change	(-) 2.0bps
Carry Score	0	1	2

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)

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. Italy: Natixis Investment Managers International Succursale Italiana, Registered office: Via San Clemente 1, 20122 Milan, Italy. Netherlands: Natixis Investment Managers International, Nederlands (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. Germany: Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Senckenberganlage 21, 60325 Frankfurt am Main. 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 (register no. 190258) - registered office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER. 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 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 is part of NIM Singapore and is not a separate legal entity. Business Name Registration No. of Mirova: 53431077W. 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 Chile: Esta oferta privada se inicia el día de la fecha de la presente comunicación. La presente oferta se acoge a la Norma de Carácter General N° 336 de la Superintendencia de Valores y Seguros de Chile. La presente oferta versa sobre valores no inscritos en el Registro de Valores o en el Registro de Valores Extranjeros que lleva la Superintendencia de Valores y Seguros, por lo que los valores sobre los cuales ésta versa, no están sujetos a su fiscalización. Que por tratarse de valores no inscritos, no existe la obligación por parte del emisor de entregar en Chile información pública respecto de estos valores. Estos valores no podrán ser objeto de oferta pública mientras no sean inscritos en el Registro de Valores correspondiente.

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 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 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 authorised. 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. 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. May not be redistributed, published, or reproduced, in whole or in part.

Amounts shown are expressed in USD unless otherwise indicated.

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