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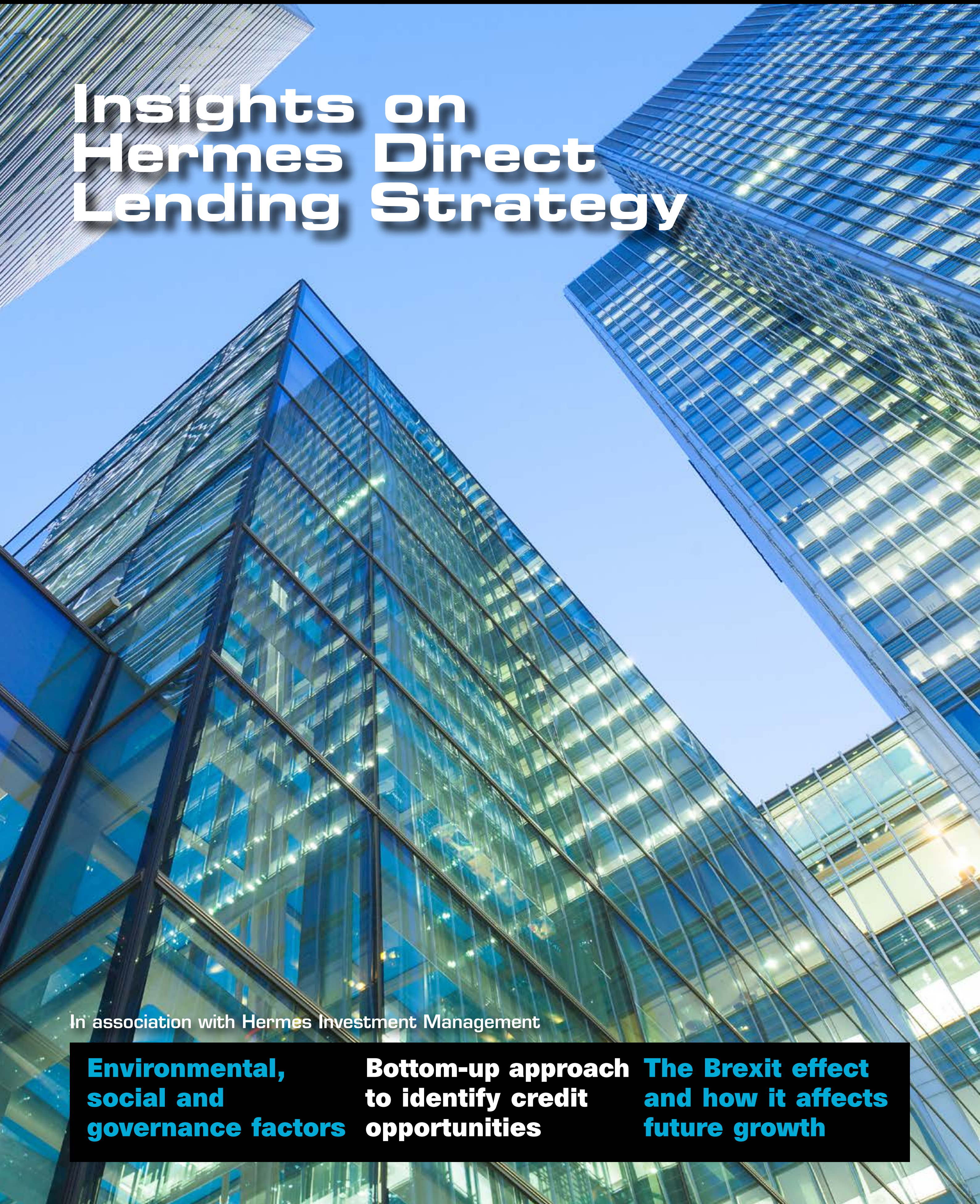

Insights on Hermes Direct Lending Strategy

In association with Hermes Investment Management

Environmental, social and governance factors

Bottom-up approach to identify credit opportunities

The Brexit effect and how it affects future growth

Insights on Hermes Direct Lending Strategy

By James Williams

Introduction

Europe's direct lending (or private debt) market continues to flourish as M&A activity picks up and small and mid-sized enterprises (SMEs) look for alternative financing, beyond the banks, to support future expansion and R&D. The region mirrors what has happened in the US over past decades where non-banking, institutional sources of financing have long prevailed. Around 70 to 80 per cent of corporate America is financed this way.

Whilst it still lags a fair way behind the United States, Europe, and more specifically the UK, is on a clear growth trajectory.

Since 2012, European direct-lending loan volumes have surged 120 per cent year-on-year, with an estimated 86 funds raising more than GBP50 billion.[1] As Preqin noted in its Q2 2017 private debt report[2], Europe had a total of USD39.1 billion of targeted capital.

The UK remains the largest direct lending market in Europe, having hosted 47 per cent of regional transactions in 2014. According to the Deloitte Alternative Lender Deal Tracker Q3 2017[3] the UK market grew 35 per cent year-on-year.

As such, its loan market provides compelling return opportunities.

Senior-secured Term Loan B transactions with SMEs have typically generated LIBOR plus 3.5-5.5 per cent margins, with upfront fees of 2-3 per cent, producing attractive total yields. Since 2009, they have consistently provided about 55 basis points more margin than large-cap transactions.[4]

Private debt appeals to institutional investors as it offers them a way to increase investment yield in a continued low interest rate environment. Moreover, regulatory pressures such as Basel III have caused

Sources:
1. *The rise and rise of direct lending, Private Debt Investor Dec/Jan 2015.*
2. *http://docs.preqin.com/quarterly/pd/Preqin-Quarterly-Private-Debt-Update-Q2-2017.pdf*
3. *https://www2.deloitte.com/uk/en/pages/financial-advisory/articles/alternative-lender-deal-tracker.html*
4. *LCD, an offering of S&P Global Market Intelligence.*

European banks to retrench and limit their loan activities in the mid-market.

This has provided a significant opportunity for asset managers, such as Hermes Investment Management, whose Direct Lending Strategy is overseen by Patrick Marshall, Head of Private Debt and CLOs.

The strategies provide senior secured and unitranche loans to UK and Northern European mid-market businesses. Currently there are two strategies on the platform, one focused on the UK, and the other focused on Scandinavia, Germany and Benelux. The strategies target gross annualised returns of LIBOR plus 6 per cent and EURIBOR plus 5.0 – 6.0 per cent respectively.

In terms of loan composition, the UK strategy comprises approximately 75 per cent UK loans and up to 25 per cent European loans, while the European strategy comprises 65 per cent European loans and up to 35 per cent UK loans. On average, three quarters of the loans in both strategies will be senior secured and one quarter unitranche loans, with a six- to eight-year maturity.

"Deal flow has really picked up," says Marshall. "This is partly because the M&A pipeline is finally coming through and also because private equity firms are looking to realise their investments and selling; either way it is proving to be a buoyant market."

He says that the Hermes Direct Lending Strategy is designed to do two things for investors.

"The first is that it is a low risk entry point into direct lending. The second is to provide yield over the life of the strategy, such that investors can use it for liability matching purposes in their portfolios.

"All of our loans are floating rate senior secured loans meaning our investors benefit from upside in a rising rate environment and at the same time, all of our loans have LIBOR or EURIBOR floors. This means if interest rates are cut, our investors are protected on the downside."

In short, the strategy provides Hermes' investors with low volatility exposure to loans with a natural hedge against inflation. Each senior loan that Hermes issues also has a leverage cap of 5.5x, to further reassure investors that undue risk is not being taken.

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Patrick Marshall, Hermes Investment Management

Assessing the creditworthiness of small and medium-sized enterprises (SMEs)

There are numerous aspects to the way Hermes performs fundamental credit analysis before issuing loans to determine a company's business risk, financial risk and structural risk.

This involves meeting with the management team and in some instances a site visit. The team then puts forward rough guidelines on the opportunity to the investment committee and, subject to receiving approval from the committee, they will then do three things.

The first is to conduct business and industry analysis, which often involves engaging with independent third party due diligence experts to assess the commercial aspects of how the company operates.

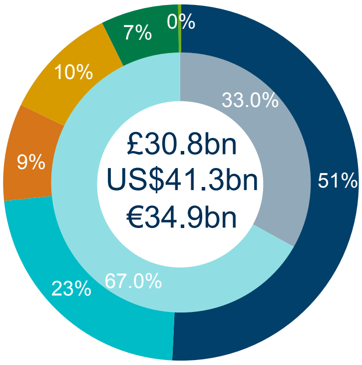
Secondly, the team will then build a risk model based on how they view the future holdings of the company and then determine a base case. "Then, we will determine a downside case where the analysts will stretch various inputs within the model to see what impact stressed market conditions would have on the company.

"In the third step of the process, the team does financial and legal analysis on the loan documents before coming back to the investment committee to present the full package. Subject to getting approval, the team will then start negotiating the loan documentation and will revert to the investment committee on the outcomes of those negotiations," says Marshall.

The board has the final say before any investment is made.

Hermes Investment Management

A diversified platform



Assets under management

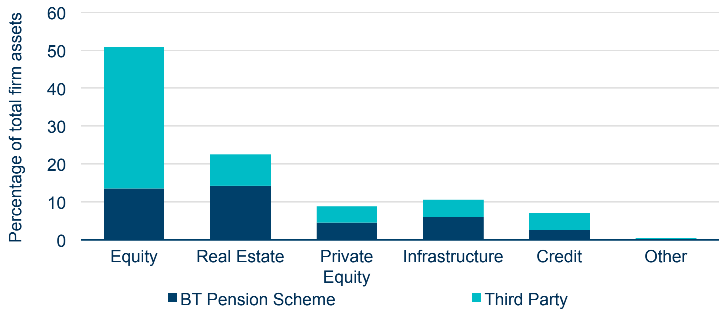
- Equity
- Real Estate
- Private Equity
- Infrastructure
- Credit
- Other

Q3 2017 revenues

- BT Pension Scheme
- Third party

Total AUM (millions)

	Equity	Real Estate	Private Equity	Infrastructure	Credit	Other
GBP	15,638	6,947	2,718	3,237	2,173	79
USD	20,981	9,321	3,646	4,343	2,915	105
EUR	17,748	7,885	3,084	3,674	2,465	89



- Owned by the **BT Pension Scheme**
- **118** investment professionals located in London, Singapore and New York
- A leader in stewardship, with **£317.1bn/US$424.9bn/€359.7bn** in assets under advice

Please note the total AUM figure includes £6.0bn/US$8.0bn/€6.8bn of assets managed or under an advisory agreement by Hermes GPE LLP ("HGPE"), a joint venture between Hermes Fund Managers Limited ("HFM") and GPE Partner Limited. HGPE is an independent entity and not part of the Hermes group. £76.3m/US$102.4m/€86.6m of total group AUM figure represents HFM mandates under advice. Source: Hermes as at 30 September 2017 with the exception of two portfolios totalling £12.5m/US$16.8m/€14.2m valued as at 30 June 2017.

Environmental, social and governance (ESG) considerations

ESG factors are also an important part of the analysis of companies.

This is important for two reasons: firstly, perception. Hermes has very strong ESG policies and has to uphold these principals in any companies into which it enters a loan arrangement.

Secondly, ESG risks could affect a company's ability to repay Hermes.

"Understanding those ESG risks, for any company we lend to, is very important. It is a key part of our work and if needed we will undertake environmental due diligence before lending. We report to investors on any ESG issues that might arise in any of our portfolios, on a quarterly basis," adds Marshall.

The power of origination

Marshall and his team take a considered, bottom-up approach to identifying the best credit opportunities. In that sense, they maintain a position of always being credit pickers rather than credit takers – whereby the manager is forced to make investments because of myriad pressures, such as lack of deal opportunities, etc.

"If you speak to a US fund manager, their biggest complaint about the European market is that it remains a bank-led market," states Marshall. "We've taken the decision to work with banks rather than against them.

"We have signed a number of co-lending agreements with banks, who are legally obliged to show us loan opportunities that they see in their regions. We have agreements in place with four banks: Royal Bank of Scotland for the UK, Danske Bank for the Nordics, DZ Bank for Germany and KBC Bank to cover Benelux. All of these banks are top-three lenders in their respective regions.

"If we like what we see, our team will go with the respective bank to conduct due diligence on the company, independently of the bank, and we will co-lend on roughly the same economic terms."

This point about doing independent due diligence is important. These are not syndicated loans that Hermes gets involved in. Each loan is made in Hermes name, alongside the partner bank. This means it benefits from all the upfront fees.

"I would estimate that this accounts for around 75 per cent of the loans we make," adds Marshall. The other 25 per cent are self-originated loans. This part of the deal

Hermes Direct Lending Strategy

Benefits of investing in SME loans

Strong yield in a low-yield environment

- Stable returns in the last 8 years, despite the financial crisis
- Illiquidity premium of approximately 60bps
- Mid-market loans currently offer about 55bps additional yield compared to large-cap transactions (through higher fees)
- Spread per unit of leverage has remained strong, reducing pricing risk

Protection against downside risk and inflation

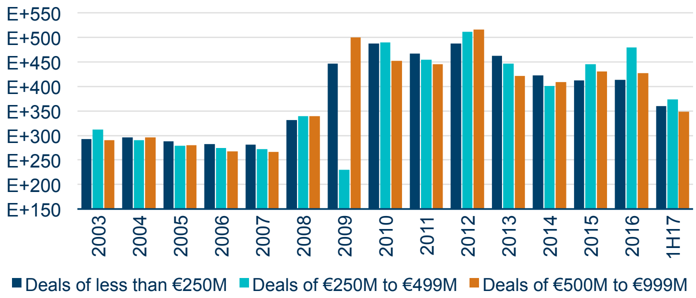
- First ranking and specific security on cash flows and assets
- Floating-rate coupons rise with inflation
- Advantageous terms and covenants can be negotiated, providing controls and detailed information on borrowers

The value of investments and income from them may go down as well as up, and you may not get back the original amount invested.

Low volatility with high recovery rates

- Low mark-to-market volatility provides stability to a diversified portfolio
- Average historical recovery rate of more than 70% in the event of default

Average European Term Loan B primary spread by deal size[1]



[1] Source: S&P Capital IQ as at August 2017. Chart shows performance of first-lien bullet term loans.

flow comes from Hermes' extensive network of contacts among private equity houses, debt advisors, corporate treasurers, and legal and accountancy firms.

The banking relationships that Hermes has in place support its ability to be an effective credit picker. Asset managers who self-originate loans in Europe might, on average, see 100 to 120 opportunities per year, rising to 200 for the very largest.

But as Marshall confirms, the banks it works alongside to originate loans present the team with anywhere between 700 to 800 opportunities per year.

"In a difficult market, we are able to choose industries and companies that we really like; we aren't forced into doing dangerous investments to deploy capital. We make a big point at Hermes of lending to companies with good stable cash flows, who aren't seeking to re-invent the wheel and don't need our money in order to get out of a difficult situation. They are very established companies," remarks Marshall.

He says that in both direct lending strategies, no single industry can be more than 20 per cent of the total AUM. Industry sectors tend to include business services, healthcare, education, financials and insurance.

Today, the market conditions for lending to private equity-owned companies in Europe are favourable. There is currently an estimated EUR300 billion in dry powder. Moreover, Europe has a leveraged loan 'maturity wall', such that approximately EUR62 billion of loans are set to mature between now and 2021, requiring companies to seek new loan arrangements ahead of time.

Risk mitigation

Hermes takes a multi-pronged approach to ensuring that downside risk is controlled.

The first part of this is to only lend to businesses at the senior secured level of the capital structure to businesses. "In our loans we would tend to have around 50 per cent of equity ranking behind us. If there were a problem, at least 50 per cent of equity would need to disappear before we see a loss.

"The reason we are senior secured is because of where we are in the market, it's best to be at the top of the capital structure. It's an aggressive market," says Marshall.

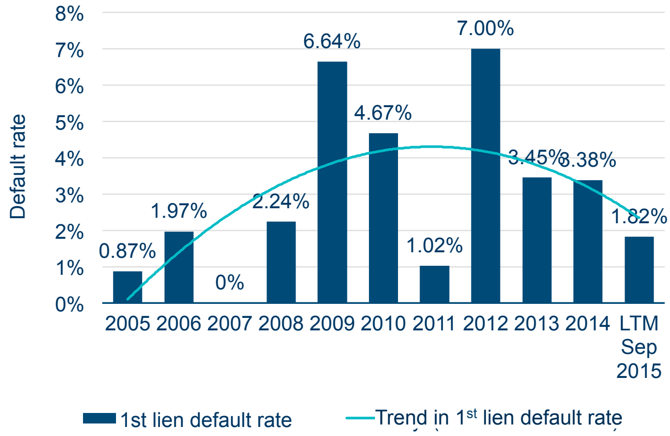
Default rates for European senior secured loans have remained highly robust. Average first lien default rates were just 3 per cent between 2005 and 2015, while recovery rates have persisted above 70 per cent

Market overview

Default and recovery

- European default levels remain persistently low
  - 1st lien default rate of 3% from 2005 to 2015[1]
- Mean 1st lien recoveries were 74% in 2014 and have consistently been above 70% across the whole of Europe in recent years[2]
  - Outcomes for second-lien and mezzanine debt are typically binary, with zero recovery more likely
- Smaller debt issuers benefit from higher mean 1st lien recoveries
  - Mean of 76% v 71% for larger debt issuers[2]

European default rates: 1st lien leveraged loans, 2005 to Sep 2015[1]



[1] Source: "Leveraged finance default review" by Jonathan Blau et al. Published by Credit Suisse Fixed Income Research, Global Leveraged Finance Strategy on 14 October 2015.
[2] "2014 European Empirical and Recovery Rating Performance Update Shows Continued Strong First Lien Recoveries", published by S&P Ratings Service on 20 May 2015.

(averaging 74 per cent in 2014, for example) for many years.

To put that in perspective, in the high yield market the recovery rate is in the 20 to 30 per cent range.

"The second thing we do to mitigate risk in the strategy is to only target what I call the most creditor-friendly jurisdictions in Europe," explains Marshall. "Those jurisdictions where, in a default scenario, the legal environment is very pro-creditor i.e. northern Europe. In these markets, on average recoveries are in excess of 80 per cent; to put that in perspective, in southern Europe it is closer to 50 per cent and in the United States it is approximately 75 per cent.

"The third way we mitigate risk is only to lend to SMEs, which we define as those with anywhere from GBP5 million to GBP75 million in EBITDA; our sweet spot is GBP5-35 million. We do this because if we lend to large-cap corporates, there is nothing to stop them issuing bonds. That means, as a lender I have to accept bond-like structures in my loan agreements, which gives rise to 'covenant-lite' conditions and far fewer lender protection rights."

As with all financial investments, there are pros and cons. The advantages to lending to SMEs are that it gives Hermes more robust lender protection rights and security over the assets of the strategy. Also, because there is less liquidity, Marshall estimates that this can result in a liquidity premium of around 75 to 80 basis points.

The disadvantages to investing in SMEs is that there is far more liquidity in the large-cap space although as Marshall points out: "What I've learned throughout my career is that when you want liquidity in the large-cap loan space it tends to be in a down market when liquidity comes at a significant price. So it's better to have more robust protection rights by lending to SMEs and getting a liquidity premium at the same time."

The fourth aspect to risk mitigation is to maintain a diversified pool of loans in the portfolio. On average, individual loans in direct lending funds typically represent 5 to 7 per cent of the portfolio's total AUM.

"In our case, it is closer to 2.5 per cent in the UK fund, rising slightly in the European strategy," confirms Marshall.

Ongoing loan monitoring

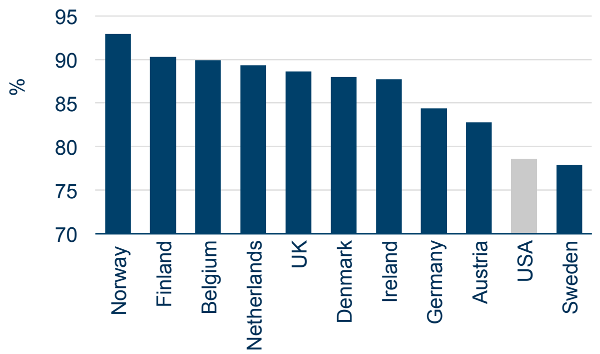
Once the loan is put in place the team will commence active monitoring of the loan, which is as important as the initial investment.

Market overview

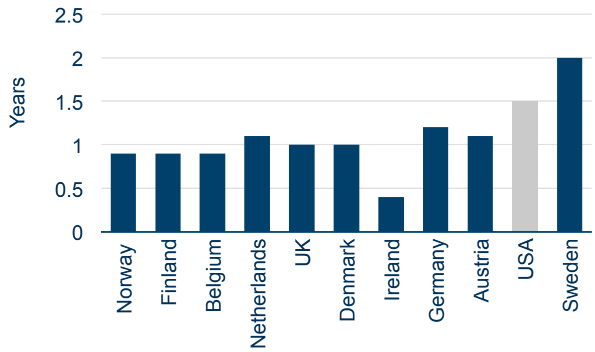
Europe v USA: Insolvency and recovery timeframes

- Compared to US-focused direct lenders, investors in the majority of North European countries benefit from:
  - Stronger recovery rates in insolvency situations
  - Shorter restructuring periods
  - Only Sweden lags the US

Recovery rates in an insolvency: Europe v USA



Average restructuring periods: Europe v USA



Source: The World Bank as at December 2016

Monitoring is based on four pillars:

- Daily news feeds;
- Weekly monitoring – reviewing the pipeline and material credit issues;
- Monthly monitoring – financials received from each portfolio company, which Hermes models against its expectations (including reviews of KPIs, covenant headroom and liquidity);
- Quarterly portfolio review – portfolio performance reviews on each loan and forecasts for underlying borrowers, covenant compliance, assessing any changes in management and business fundamentals.

One can appreciate just how important the monitoring process is when one considers events such as the recent GBP1.5 billion of Carillion, a major UK construction services company. Its demise has had a serious knock-on effect on small and mid-cap companies who had contracts with Carillion.

Hermes' UK direct lending loan portfolio concentrates on the UK mid-market, which consists of about 34,100 companies employing a total of 4.2 million people. UK mid-market companies typically generate EBITDA of GBP5 million to GBP75 million and enterprise values of GBP50 million to GBP750 million.

"There are always going to be things that happen in the portfolio that you can't foresee, but when they do happen that's why daily monitoring is so important. What's the news, is anything happening that might impact the portfolio and if so, what are we doing about it?

"What we seek to do, at all times, is to structure loans so as to mitigate as many of the risks as we can. We position the loan at the top of the capital structure, we try and ascertain all the risks that we can think of that could happen – we might model, for example, what would happen to a particular company if interest rates climbed 2 per cent, 4 per cent, etc – but there is always going to be something unexpected that you can't foresee. In such a situation, we want to be as well protected from downside risk as possible," outlines Marshall.

The Brexit effect...

Brexit is of greater potential concern to the UK direct lending market than isolated incidents. Companies who employ large numbers of EU nationals are unlikely to succeed in securing loans in the market because of the continued fall-out over Brexit. Three years ago, this would not have been a concern.

From a macroeconomic perspective, Brexit has not negatively impacted the UK economy as first feared. The stock market has hit record highs, thanks to a seriously weakened sterling.

This has attracted a lot of foreign investors who take the view that sterling looks cheap over the medium term, fuelling renewed M&A activity.

The flipside to this is that in the loan market a number of European banks who are funded primarily in euros are facing domestic pressures as to why they would put their books out in GBP. With the improvement of the economies in continental Europe, why should European banks lend in the UK? They've pulled out and as a result, whereas the sterling loan market nearly always priced at a premium to euro loans (due to there being less liquidity in the sterling loan market), it has since climbed a bit higher.

"If you've got a sterling loan fund and you don't have to hedge to lend in sterling, you are benefiting from upside. Investors view the UK market as one of the most creditor-friendly jurisdictions in the world and there is an argument for them to invest in UK loans and benefit from 75 to 80 basis points' more premium," explains Marshall. Prior to Brexit, the premium on sterling loans versus euro loans was more like 50 basis points.

Future growth

The UK still remains a major part of the European direct lending market but it is becoming more competitive, with Marshall noting that he saw improved deal flow in Europe last year. European banks are lending again and competition is no longer based solely on price – it is primarily based on the terms of loans being originated.

"In the mid-market we've seen a few people try to do covenant-lite loans, which has broadly been met with resistance. On the side, people are diluting creditor protections. That's why it is important to be a credit picker not a credit taker. We see so many opportunities that we are able to walk away from those that are too aggressive," he says.

That banks are lending again could, by some, be viewed as a potential impact on the future growth of Europe's direct lending market – could the region revert to classic bank-driven loan financing at the expense of continued institutional expansion? Marshall does not believe so.

"I don't see things reversing. Alternative lenders have become an established part of the European market. I can't envisage a situation where they disappear. If, however, there are suddenly lots of losses among some of the riskier alternative lenders, who aren't being transparent around the risks of unitranche loans, they might struggle to raise future funds.

"I think the loan market for alternative lenders is going to transition from an alternative asset class to a mainstream asset class as more institutional money comes in. And that will see a continued 'Americanisation' of the European markets. I don't see a situation where the banks go back to controlling things," concludes Marshall. ■