

Opportunities in Stressed European Credit

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October 2022

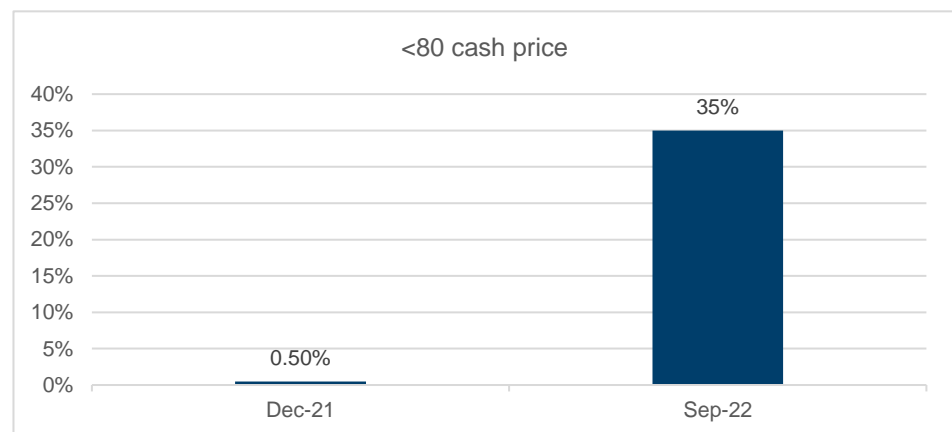
The cyclical challenges that lie ahead for the Pan European region are immense and mounting by the day. Over 35% of the Pan European HY market is trading below 80 cents and we believe flexible capital solutions will be needed to help companies navigate this new environment

The end of easy money:

It is clear for all to see that central banks are taking the inflation threat seriously with the ECB priced to raise rates to around ~3% and the BOE to a staggering 5.8% by 2023. The impact of higher interest has not just impacted total returns in fixed income but also the business models of many companies who functioned primarily through the availability of cheap funding. The velocity of the increase in rates and resultant volatility, cautious risk sentiment and a lack of dry powder within the fund management industry has also led to a death of new issue supply YTD. These conditions are likely to continue for the foreseeable future and existing debt refinancings will need to compete with potential new deals to fund recent private equity purchases. The likely result of this scenario is an increase in the amount of stress and distress in the Pan European HY market as issuers approach final maturities.

The aggregate value of bonds trading below €80 has increased from 0.5% of the entire universe to 35% in September 2022. The opportunity set is vast and diverse, with over 300 issuers with an aggregate face value of €147 billion trading in stressed territory.

Figure 1. Percentage of Pan European HY bond market trading below €80 cash price



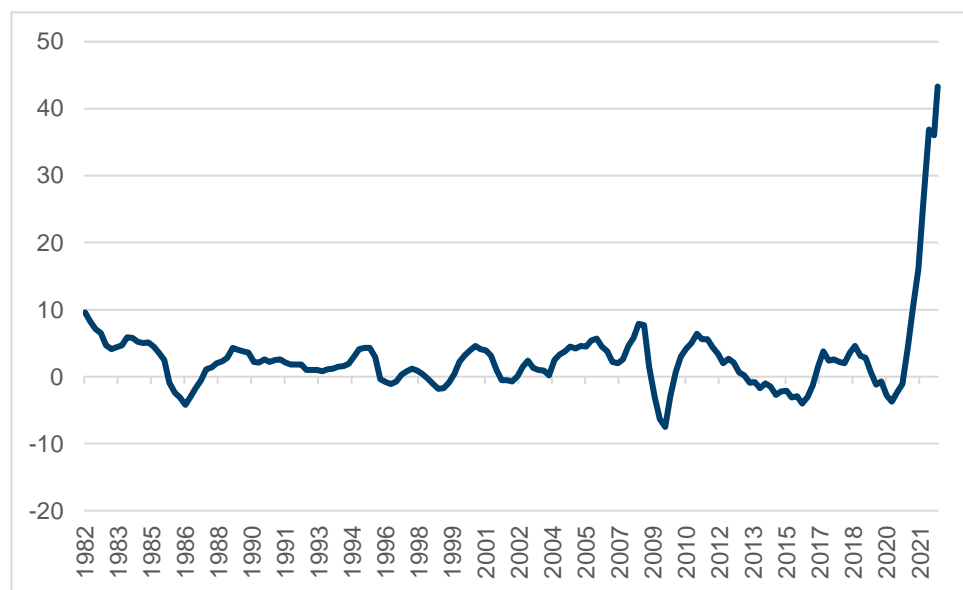
Source: Bloomberg, ICE BofAML as of 30 September 2022

The European leveraged loan market may find itself in an even more precarious situation with over 70% of issues not hedged from a rising rate environment with loans issued presuming a low interest rate environment. The stress is not likely to end there as the lack of covenants in loans will also likely lead to lower recoveries than what has been previously experienced in this asset class.

- **The scourge of inflation continues to fester.**

Of course, the rationale for tightening policy has been the spectre of higher inflation witnessed globally, with exaggerated levels in the Pan European area. Looking deeper, we remain more concerned about the impact of higher input prices on margins and ultimately cashflows, which could indeed turn negative for certain companies. The dramatic spike in energy prices will certainly hit cyclical industrials that rely heavily on not only energy to run factories, but also on the cost of other raw materials which have been spiking simultaneously. Another likely domino to fall is companies who failed to hedge against such spikes and already operate in a business with thin margins, such as those in the grocery, paper, and packaging spaces. While we may be nearing the tail end of the inflation spike as slowing growth reduces aggregate demand and we start to become more fearful of a deflationary bust, the impact on corporations will be significant and increase the stressed opportunity set.

Figure 2. Eurozone PPI at all time high levels

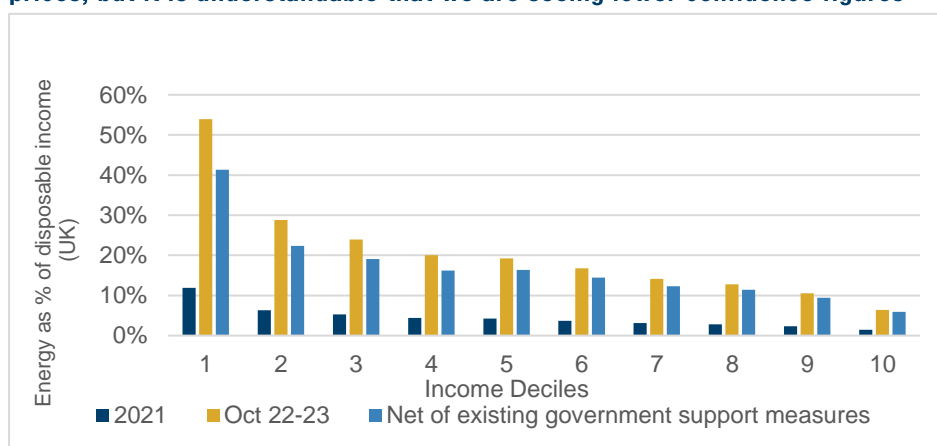


Source: Bloomberg and Eurostat as of 31 August 2022

- **The lagged effect of tighter policy will be slower growth.**

There are few certainties in life, but with the myriad of risk factors impacting Europe we feel that a best-case scenario of slowing growth and a recession as a base case, would be a safe bet. Leading economic indicators are pointing to slowing output relative to potential as well as a stark deterioration in the momentum of these indicators. Additionally, the consumer is in a very challenged position with lower discretionary income as a result of higher energy and mortgage costs, which in turn impacts consumption. This is a recipe for slowing growth, reduced profitability and in our opinion more stress amongst cyclical industrials, autos and retail/consumer goods focussed sectors.

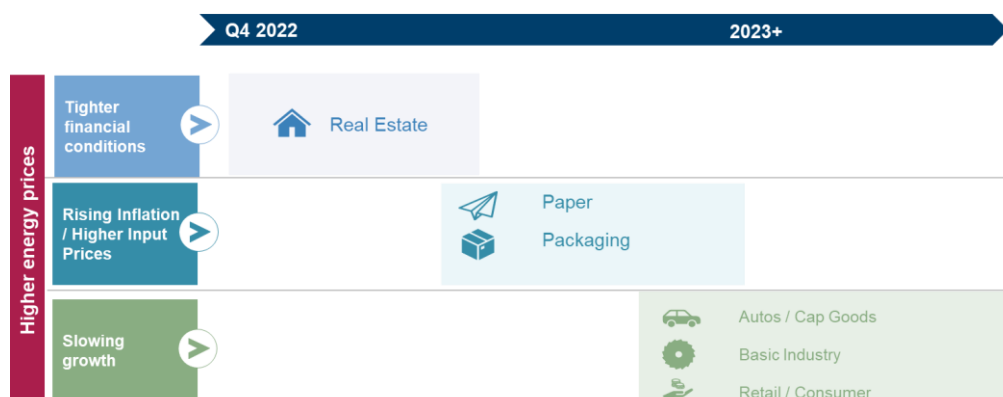
Figure 3. Recent government action will likely defer the pain of higher energy prices, but it is understandable that we are seeing lower confidence figures



Source: ING, Financial Times as of September 2022

- Flexible capital solutions can help companies deal with near term problems

In terms of a sequence of events we believe the following sectors are likely to be in frame as potential investment opportunities



Our universe of potential investments has started to increase with the amount of debt trading at >800 bps standing at €55b face value across 117 issues.

Issues > 800 bps

Sector	Face Value (€, bn)	% of sector	Number of issues
Real Estate	10.2	44%	23
Paper / Packaging	2.4	14%	6
Automotive	5.3	12%	11
Capital Goods	4.4	16%	11
Basic Industry	8.8	25%	19
Retail	15.9	51%	30
Consumer Goods	2.4	16%	4
Services	6.0	21%	13
Total	55		117

We have also summarised some recent opportunities that that we think provides attractive forward-looking returns for longer term oriented investors

Potential deals:

Sector: Consumer staples / Grocery # 1

Source: The team have been following the name for over a decade and has been invested in the name sporadically over that time frame. Strong understanding of business model, key risks relative to peers and performance through the cycle

Why is it stressed? Competitive pricing from low-cost peers and company specific issues in terms of the impact of rising energy costs on margins

What is our view? Fears over energy costs are overblown even in pessimistic scenarios within our models. Recent government support should also provide a support in the near term. Market pricing in extra premium for UK PLC assets

Current price: £75

Spread: 1308 bps

YTW: 17.6%

Coupon: 4.625%

Maturity: 2025

Potential return – Base case IRR of 15%

Sector: Consumer staples / Grocery #2

Source: The team have been following the name since the new issue in 2021 to fund the leveraged buyout. We passed on the deal at the time given the tight issue spreads of 310 bps relative to the leverage and acquisition history of management.

Why is it stressed? Higher interest rates in the UK has negatively impacted a number of companies in the mortgages, bridging loans and auction finance space.

What is our view? Underlying fundamentals remain sound and the recent sell-off in UK assets has created an attractive valuation window

Current price: £76

Spread: 769 bps

YTW: 12.0%

Coupon: 3.25%

Maturity: 2026

Potential return – Base case IRR of 10.2%

Sector: UK Financial

Source: Followed the issue since new issue in 2021 and are familiar with the segment of the market

Why is it stressed? Competitive pricing from low-cost peers and company specific issues in terms of the impact of rising energy costs on margins

What is our view? Fears over energy costs are overblown even in pessimistic scenarios within our models. Recent government support should also provide a support in the near term. Market pricing in extra premium for UK PLC assets

Current price: £70.7

Spread: 1101 bps

YTW: 15.2%

Coupon: Cash: 6.75% / PIK: 7.5%

Maturity: 2027

Potential return – Base case IRR of 15%

Sector: Real estate

Source: The team had experience in the name and sector previously but did not hold the position in our funds.

Why is it stressed? Noted short seller published a report last year which highlighted some governance deficiencies and questions over valuations of certain assets. It remains a complicated capital structure, but we started to dig into the real estate subsidiary

What is our view? Strong asset coverage with properties in prime areas across Germany, our position in the capital structure and the first maturity coming due next year gives us added confidence on the potential of the trade.

Market pricing: €82.8

Spread: 4124 bps

YTW: 42%

Coupon: 1.875

Maturity: 2023

Potential return – Base case IRR of 41%

Sector: UK Consumer Discretionary

Source: Provided rescue finance to the company (20% IRR) post March 2020 Covid induced sell-off

Why is it stressed? Difficulties refinancing existing rescue financing

What is our view? We believe the company is well managed and cash flow positive and that flexible capital solutions such as finding a third-party buyer with the proceeds used to pay back existing bondholders

Current price: £78.5

Spread: 9756 bps

YTW: 100.6%

Coupon: Cash: 6.75%

Maturity: 2023

Notes and disclaimers

Past performance is not indicative of future results. Returns may increase or decrease as a result of currency fluctuations.

Investor Considerations

One should carefully consider the risks associated with investing, whether the strategy suits your investment requirements and whether you have sufficient resources to bear any losses which may result from an investment:

Investment Objective Risk - There is no guarantee that the Strategy will achieve its investment objective.

Market Risk - The Strategy is subject to normal market fluctuations and the risks associated with investing in international securities markets and therefore the value of your investment and the income from it may rise as well as fall and you may not get back the amount originally invested.

Counterparty Risk - The Strategy will be exposed to credit risk on counterparties with which it trades in relation to on-exchange traded instruments such as futures and options and where applicable, 'over-the-counter' ("OTC", "non-exchange") transactions. OTC instruments may also be less liquid and are not afforded the same protections that may apply to participants trading instruments on an organised exchange.

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Liquidity Risk - The Strategy may make investments or hold trading positions in markets that are volatile and which may become illiquid. Timely and cost efficient sale of trading positions can be impaired by decreased trading volume and/or increased price volatility.

Concentration Risk - The Strategy invests in a limited number of investments may be held which can increase the volatility of performance.

Financial Derivatives - The Strategy will invest financial derivative instruments ("FDI") (instruments whose prices are dependent on one or more underlying asset) to achieve its investment objective. The use of FDI involves additional risks such as high sensitivity to price movements of the asset on which it is based. The extensive use of FDI may significantly multiply the gains or losses.

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