TAKING A DISCIPLINED APPROACH TO AN EVOLVING EUROPEAN PRIVATE CREDIT MARKET

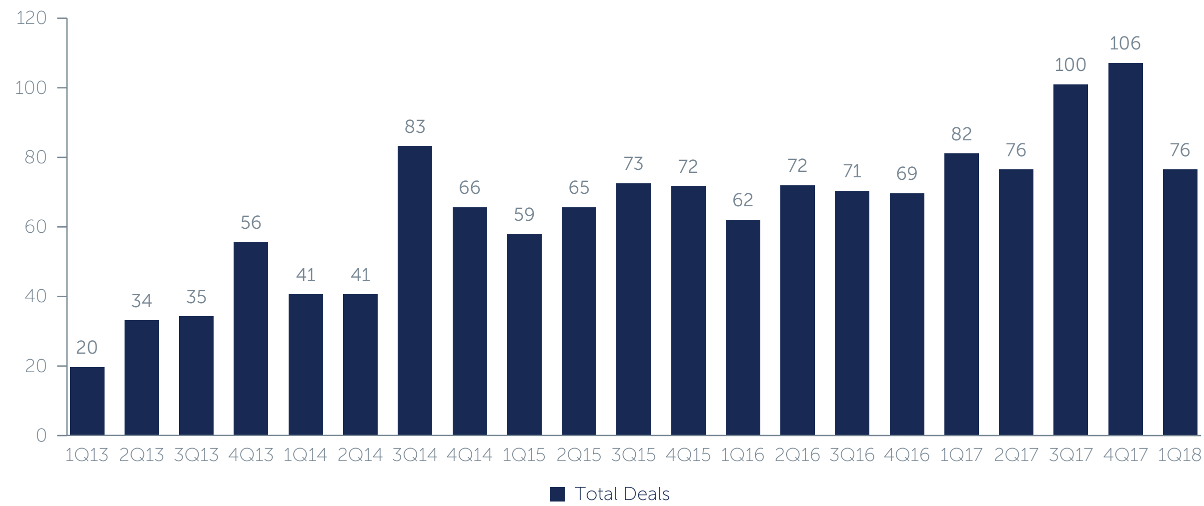
The trends and dynamics underlying the European private credit market have shifted in recent years, creating what we believe is an attractive investment opportunity, particularly for long-term investors. Increased regulation and challenging market conditions have continued to limit the activity of banks, creating a gap in the market for direct lenders to fill the shortage of capital. Lenders with the ability and willingness to meet the financing needs of middle-market companies have gained access to a diverse set of investment opportunities with a potential yield premium compared to the broadly syndicated loan market. The key, in our view, is to achieve a disciplined approach in this evolving market, rather than chasing yield through investing in either higher leveraged packages, or those with looser covenant structures. Both of these options increase risk in an attempt to maintain absolute performance, which can actually reduce their overall risk-adjusted return. Asset selection is therefore critical.

FINDING A SWEET SPOT

The European market has evolved considerably in the past decade, and it is in the middle of two distinct ends of this market's spectrum that we believe lies a lucrative opportunity. Banks, at one end of the spectrum, have been restricted to holding smaller pieces of debt following the financial crisis. Regulations under Basel III imposed additional capital requirements and heightened underwriting standards on banks, forcing them to simplify and reduce leverage, which has impacted their ability to lend to borrowers. A private equity house considering a €150 million debt funding requirement, for example, may have to seek out as many as 10 banks to source the capital, which creates complexity.

At the other end of the spectrum is the broadly syndicated loan market, which is typically focused on debt packages of €250 million and above. This market is relatively liquid with larger pools of capital providing financing to typically larger companies. Not only does this market have considerably more competition, but there can be fewer protections for the lender in the form of financial covenants. In between the two distinct ends of this spectrum is what we see as a sweet spot in terms of debt facilities, usually a €65 million to €150 million facility—where there is an opportunity for PE sponsors to work with just one capital provider to complete the financing. From a borrower's standpoint, it's a nice solution because they can lessen complexity and be more efficient by using just one capital provider. From an investor's standpoint, it's also attractive, because they can invest in what are often high-quality, industry-leading companies, but do so through a private credit investment where they generally earn a yield premium relative to the broadly syndicated markets, with greater downside protection in place.

FIGURE 1: ALTERNATIVE LENDER DEALS ACROSS U.K. AND EUROPE[1]



SOURCE: *DELOITTE ALTERNATIVE LENDER DEAL TRACKER SUMMER 2018*

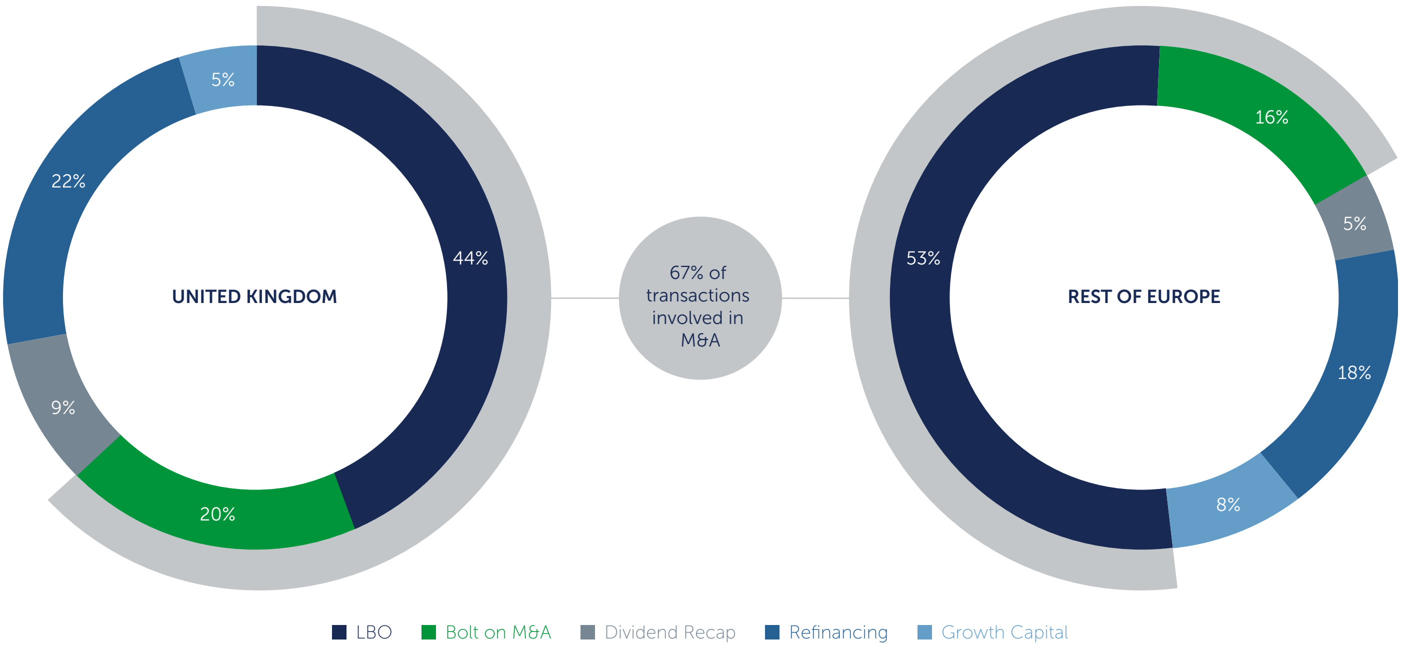
1. Currently covers 64 leading Alternative Lenders. Only primary mid-market UK and European deals are included in the survey

> *"Private credit can offer investors diversification benefits as well as the chance to seek a return premium."*

This evolution over recent years has decidedly changed how the private market is operating today, which has led to some style drift. Some managers have crept up in the size of transactions they are targeting. This puts them in competition with the broadly syndicated markets, where terms can be less favorable to lenders—including in the form of looser covenants—as borrowers have more financing options. Managers reaching for yield and absolute performance and stretching out of their traditional areas of investment can create additional risk for investors. Maintaining a consistent approach to the size of transactions a manager invests in, through the entire cycle, is an important risk mitigant.

Given the more liquid nature of the broadly syndicated loan market, holders of debt also have the option to sell out if they don't like the structure. In the private market, this is not the case, so it's crucial to have covenants in a transaction to offer structural protection in order to act in a downside situation. This is vital in managing the risk profile of a portfolio. Furthermore, in the broadly syndicated market, investors gain access to loans through traditional capital markets, whereas in the private market, managers need to both source and close their investments directly with private equity sponsors and their advisers. Given these nuances of the private market, each manager's portfolio is very different as they access investment opportunities in what has become a bilateral market. The strength and depth of the relationships built by managers over a period of time is what drives access to a broader range of potential transactions. Ultimately, investors must seek managers that fit their risk aspirations. If portfolios are constructed with a lack of discipline, investors may be exposed to a variety of risks, including weak covenant protection, excessive leverage in the portfolio or sub-standard credit underwriting.

FIGURE 2: DEAL PURPOSE (LAST 12 MONTHS)



SOURCE: *DELOITTE ALTERNATIVE LENDER DEAL TRACKER SUMMER 2018*

OUR APPROACH

At Barings, our approach to investing in the European private credit market is built upon a firm-wide commitment to rigorous, bottom-up credit analysis. We have been investing in this asset class in Europe for more than a decade and over time have formed strong partnerships with financial sponsors, intermediaries and portfolio companies. These relationships put us in a position to seek out what we believe are the most attractive risk-adjusted return opportunities for our clients.

We build well-diversified portfolios of what we assess to be low risk assets that will perform well through an entire cycle, and not just in patches. We're focused on delivering a significant premium to the broadly syndicated loan market through the cycle. Some of our strategies have a similar risk profile to that market, but we aim to deliver a return premium to compensate investors for the illiquid nature of private credit. We avoid chasing additional yield and absolute returns if they require us to stretch beyond the strict risk parameters in which we operate. We also ensure tight financial covenants are part of every deal we invest in, strengthening our position should a downside scenario occur. In addition, we maintain a broad presence across both public and private markets. When underwriting middle market lending opportunities, we can leverage Barings' large high yield team, for instance, to gain unique and valuable insight into the competitive dynamics of the market and the industries where we invest. This perspective allows us to better understand and price risk, and puts us in position to provide effective solutions across the capital structure, particularly senior debt. At a high level, this scope also gives us the ability to compare valuations and potential returns in the public and private markets to ensure investments in private credit are targeting an appropriate return premium.

In addition, we operate as a principal investor for our parent company. In that capacity, we invest a significant amount of our own capital alongside our clients in most transactions, clearly aligning our interests with those of our investors.

When investing in European private credit, our primary goal is to preserve our clients' capital. We believe that managers who are disciplined from a credit standpoint and who maintain longstanding partnerships with private equity sponsors and other market participants are best positioned to mitigate risks. While many newcomers have entered the private credit market in recent years, we believe our strong relationships with private equity firms and other deal sponsors that we have partnered with for more than a decade and through multiple cycles provide particular value when it comes to the due diligence process and understanding and pricing risk. Once a transaction is complete, these strong partnerships continue to play a critical role as we monitor our portfolios.

"To maximize the considerable opportunity that this asset class presents, choosing the right manager is critical."

DEFINING PRIVATE CREDIT

While its definition can vary from one market participant to another, we define private or direct lending as providing directly originated loans to companies that may be too small to access the public capital markets. At Barings, our Global Private Finance platform provides financing primarily to middle-market companies, with EBITDA in the €10 million to €50 million range.

Senior secured loans, which sit at the top of the capital structure, offer investors the most seniority and security. In the private market, these loans tend to include meaningful maintenance financial covenants, which can give investors in the less liquid private markets more control over the direction of their long-term investments. For instance, covenants may include language that enables investors to renegotiate the terms of a loan or require other modifications and financial support in the event that a portfolio company is under-performing. Given the importance of covenants in these transactions, partnering with asset managers that take an active approach to structuring covenants to best meet investors' long-term risk / return goals is often advantageous.

WHAT TO LOOK FOR IN A MANAGER

A SOLUTIONS-ORIENTED APPROACH

It's often beneficial to the borrower for their funding requirement to be solved through one issuer, which reduces the complex nature of negotiating with multiple providers. For investors, it can be advantageous to partner with an asset manager that has flexible capital to provide a range of financing solutions, rather than a manager offering a one-size-fits-all approach. A flexible manager can adapt accordingly if the debt package requires changes over the life of a transaction.

ROBUST ORIGINATION CAPABILITIES

Another consideration for investors to assess is the strength of their manager's origination network. Middle-market borrowers use the capital they borrow to meet a variety of needs, from funding leveraged buyouts to refinancing existing capital structures. Many transactions are sourced through private equity sponsors and negotiated directly with the sponsor or issuing company. As such, managers that have strong, established relationships with private equity sponsors and other intermediaries are best positioned to source the highest quality deals for investors. In a public market, an interested party can buy a security on a listed exchange. In a private market, that opportunity actually needs to be sourced, with a flexible capital package to move swiftly and decisively when needed.

DEEP RELATIONSHIPS, LONG TRACK RECORD

Furthermore, in a 'buy and hold' asset class like private credit, we believe experience is critical. In order to access the broadest selection of investment opportunities, investors can benefit from partnering with experienced managers who have long-standing relationships with key market participants, access to a large and diverse pipeline of opportunities, and the ability to appropriately structure and price investments. Experience investing through multiple credit cycles can be beneficial, especially as many newcomers to the asset class are not proven in times of distress. It's preferable to partner with a manager that is experienced working through restructurings, or other difficult situations that can occur in market downturns.

Conclusion

The supply and demand dynamics shaping the European private credit market have given rise to what we believe is an attractive investment environment. Even as regulatory pressure and broader market conditions have impacted banks and other lenders in the market, the demand for private finance has increased, creating attractive opportunities for lenders able and willing to provide middle market financing. From a portfolio perspective, private credit can offer investors diversification benefits as well as the chance to seek a return premium stemming from the illiquid nature of the market. To maximize the considerable opportunity that this asset class presents, choosing the right manager is critical. At Barings, we aim to build portfolios that deliver a reliable stream of risk-adjusted income over time.

Investing our own capital alongside our clients underpins our investment philosophy, which adheres unwaveringly to a bottom-up, fundamental approach to deploying capital, focusing on capital preservation, in addition to generating what we believe are appropriate risk-adjusted returns. We focus intensely on the sweet spot in the market where we can act as a sole capital provider, remaining true to our philosophy. This has served our clients successfully for more than a decade, through an entire cycle, and we believe we are well-positioned to deliver consistent risk-adjusted returns through this philosophy.

ADAM WHEELER

HEAD OF EUROPE AND ASIA PACIFIC PRIVATE FINANCE

Adam Wheeler is Head of Europe and Asia Private Finance Investments and a member of the firm's Asia-Pacific and European Private Finance Investment Committees. He is also a joint portfolio manager for Barings' Asia-Pacific focused mezzanine funds, Gateway Mezzanine Partners I & II. He is responsible for leading the teams that originate, underwrite and manage private credit investments in Europe and the developed Asia-Pacific region. Adam has worked in the industry since 1994 and his experience has encompassed mezzanine investing, private debt investing, originating, structuring and underwriting leveraged loans. Prior to joining the firm in 2009, he worked for AMP Capital Investors as the head of the Australian and New Zealand Private Debt business where he was responsible for managing a team that originated, arranged and invested in mezzanine and related private debt financings. He was also a member of the AMP Capital Private Debt Investment Committee. Before AMP, he held origination, underwriting and advisory positions at Rabobank Corporate Finance, N.M. Rothschild & Sons and PricewaterhouseCoopers. Adam holds a B.Com. and L.L.B. from the University of New South Wales, a G.D.M. from the Australian Graduate School of Management, and is a member of the Institute of Chartered Accountants in Australia and a Fellow of the Financial Services Institute of Australasia.

Barings is a $306+ billion global financial services firm dedicated to meeting the evolving investment and capital needs of our clients. We build lasting partnerships that leverage our distinctive expertise across traditional and alternative asset classes to deliver innovative solutions and exceptional service. Part of MassMutual, Barings maintains a strong global presence with over 1,800 professionals and offices in 16 countries.*

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