OUTCOMES BEYOND PERFORMANCE

HERMES SPECIALIST CREDIT

# DIRECT LENDING: POSITIONING FOR THE 'END OF THE CREDIT CYCLE'?

Institutional Money Insurance Day

**Patrick Marshall, Head of Private Debt and CLOs**
**10 September 2019**

For professional investors only

HERMES INVESTMENT MANAGEMENT

# Agenda

1. Direct Lending – Definition and Appeal

2. Different Lenders, Different Strategies

3. Current Market Conditions

4. Impact of Different Investment Parameters

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# DIRECT LENDING – DEFINITION AND APPEAL

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# Direct lending landscape

## Seeking attractive yield through direct business lending

### The opportunity

- Asset managers, pension funds, insurers, SWFs and hedge funds lend to businesses without bank intermediation
- Most loans are provided to SMEs, which are structurally unable to access the capital markets
- Opportunities to structure secured and strong-yielding loans with floating-rate coupons

### A growing market[1]

- Quantitative easing has driven the yields from government bonds and other asset classes to all-time lows, prompting investors to target higher-yielding alternatives
- As at June 2018, approximately 200 direct lending funds accounted for aggregate commitments of US$90bn globally. Almost 60 of these funds operate in Europe, compared to 12 funds in 2012
  - Providing debt at different points in the capital structure for different returns
- The UK is the largest market for private debt funds, accounting for 38% of all deals undertaken in Europe in last 22 quarters

### Huge demand for loans as banks retreat from the market

  - About €300bn of dry powder held by Europe-focused private equity funds seeking investments

### Fundraising trends[2]

- Fundraising activity has been strong for the past 24 months: 2017 was a record year for Direct Lending fundraising in both Europe and North America.
  - For example, since January 2017 four funds raised a combined total of €19.5bn
- "Gorilla" funds under significant pressure to deploy capital, forcing them to accept high levels of leverage, borrower-friendly legal terms and high portfolio concentration
  - Competing against CLO and high-yield capital markets

[1, 2] Source: "Direct Lenders: seizing opportunity in an uncertain world," published by Deloitte in Q3 2018.

# Attractiveness of direct lending

## Benefits of investing in SME loans

### Attractive yield in a low-yield environment

- Stable returns despite the financial crisis
- Illiquidity premium
- Offer better risk-return characteristics
  - Spread per unit of leverage has remained strong, reducing pricing risk
  - European loans offer attractive spreads compared to US loans, which are often subject to weaker documentation and higher loss rates

### 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 for senior secured loans

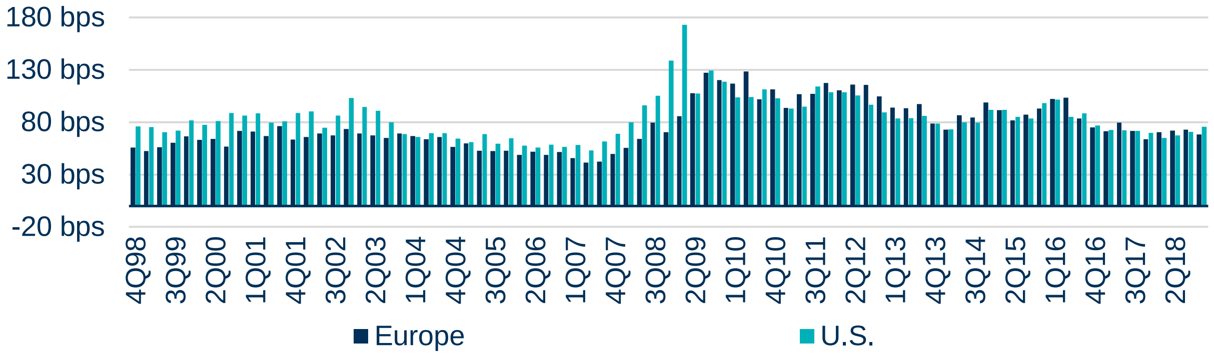
### Inflation Hedge

- Floating-rate coupons provide a hedge against inflation
- Most loans will have LIBOR or EURIBOR floors

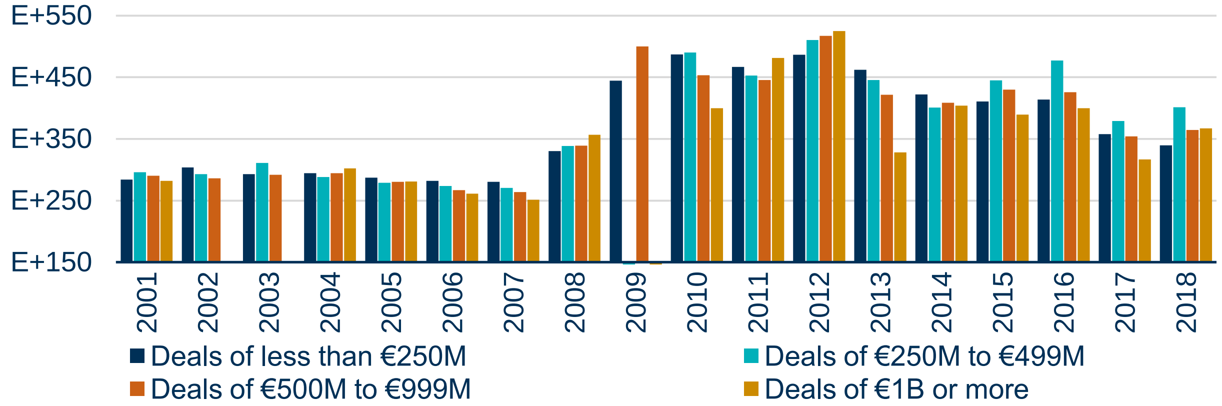
### A level of protection against downside risk

- Advantageous terms and covenants can be negotiated, providing controls and detailed information on borrowers

### Spread per unit of leverage[1]




### Average European Term Loan B primary spread by deal size[2]




[1] Source: S&P Global Market Intelligence as at December 2018. [2] Source: S&P Capital IQ as at December 2018. Chart shows performance of first-lien bullet term loans.

**Past performance is not a reliable indicator of future results.**

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# DIFFERENT LENDERS, DIFFERENT STRATEGIES

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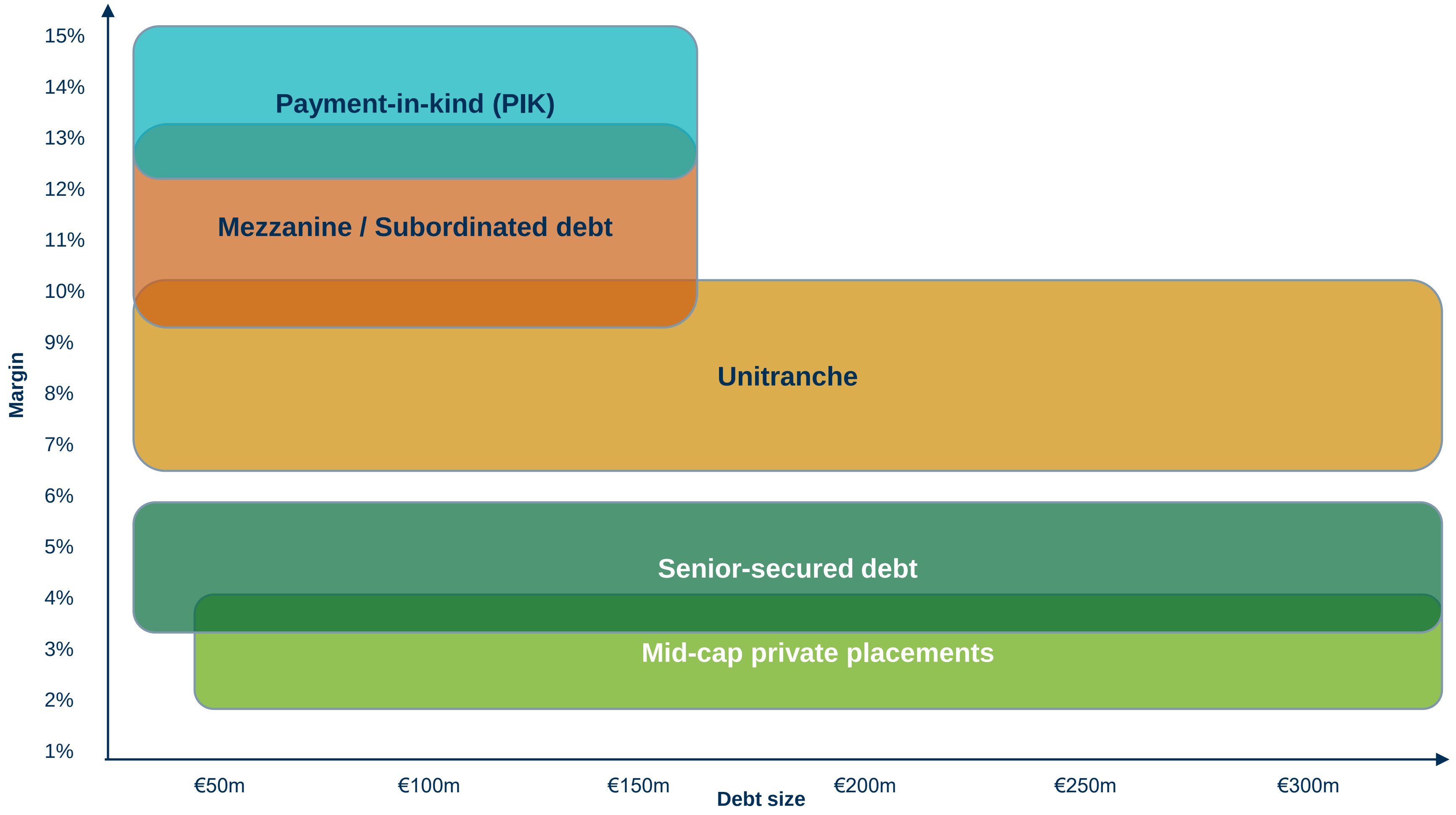
# Direct lending strategies

## Not all private debt funds compete against each other



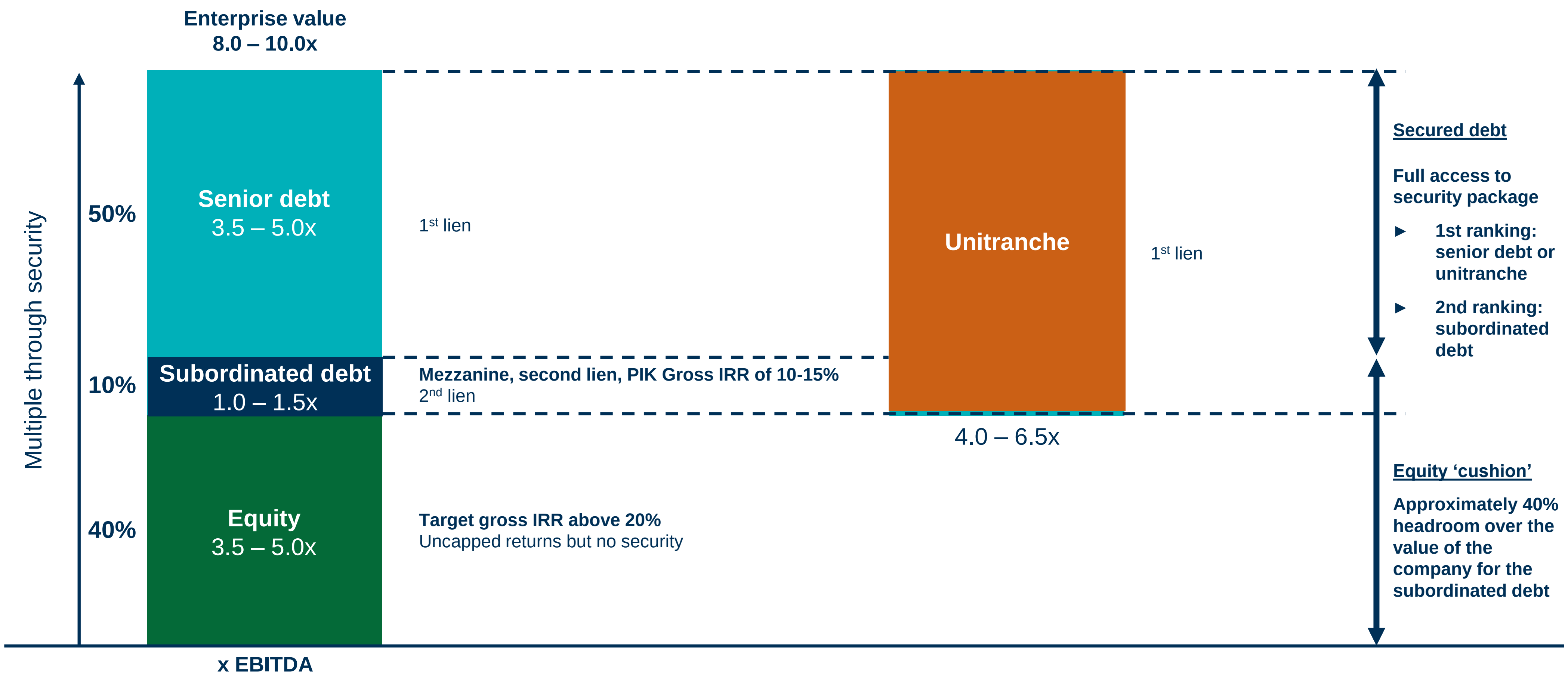

Source: Deloitte Alternative Tracker Q4 2015.

**Different target returns drive different strategies**

Direct lenders entering the market either adopt a niche strategy (by exercising industry or geographical expertise) or aim to meet a broad range of financing needs by sourcing loans across the capital structure with different security rankings and recovery potential (as a means of maximising origination opportunities and achieving returns)

# Returns and positioning within the capital structure

- Senior-secured loans – classic 1st Lien debt (i.e. at the top of the capital structure) with attractive yield
- Unitranche loans – bespoke instrument providing strong returns (blending senior and subordinated debt into single tranche)



# What are the current direct lending strategies?

## How direct lenders differentiate themselves

### Product offering

- "Story" unitranche
- 1st loss or 2nd loss unitranche
- Asset-based lending/unitranche
- Lower down the capital structure (with buckets for Mezzanine, Subordinated and Distressed debt as well as quasi-equity)

### Sourcing via co-lending agreements

- Formal and legally binding
  - Hermes, DZ Bank, RBS/Natwest, Danske and KBC
- Formal but not legally binding
- Informal

### Sponsors, sectors, jurisdictions, cov-lite

- Lending to sponsor-less companies
- Lending to more cyclical industries ('Special sits')
- Lending to less lender-friendly jurisdictions (Southern Europe)
- No cap on cov-lite transactions

### Ancillary products, hold Levels, leverage

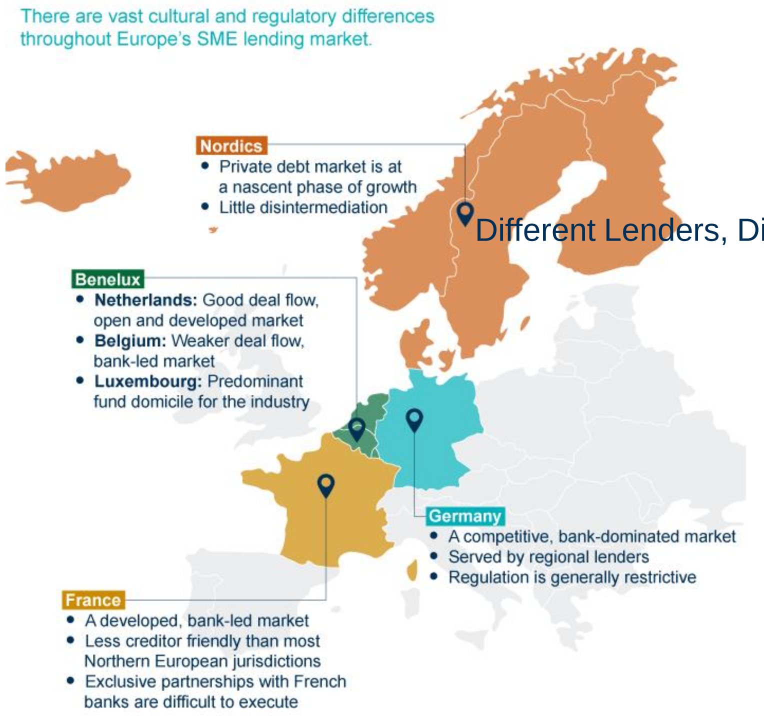
- Revolving credit facility
- Increasing loan hold strategies (with large debt hold levels)
- Use of fund leverage

# Direct lending strategies: deal sourcing

## Accessing European SME loans

- Despite ongoing disintermediation in the European market, direct lending accounts for only 10% of Europe's business loan market[1]. Companies still source all or part of their financing from banks that have fostered long-term relationships in specific regions where companies are located
- Vast regulatory and cultural differences across Europe's business landscape has hindered the pace of disintermediation
- Strong origination agreements with banks continue to be vital to access high-quality loans, particularly in the mid-market space

### Regulatory and cultural differences




Different Lenders, Different Strategies

### How can Direct Lenders unlock the SME loan market?


[1] "LCD Global Review – US/Europe", published by S&P Global Market Intelligence in April 2017

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# CURRENT MARKET CONDITIONS

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# Certain indications of a 'hot' market

## Fuelled by strong CLO issuance and the need for direct lenders to deploy capital

- Increasing preponderance of cov-lite loans, even in the mid-cap space – accounts for 87% of the large-cap market[1]
- Unitranche loans with leverage >8x for certain sectors
- Higher covenant headroom, flatline covenants
- Looser legal terms, including:
  - Generous structuring EBITDA add-backs, watering down the effectiveness of covenant tests
  - Use of EBITDA cures
  - Increased flexibility of incrementals ("Freebie" baskets etc.) and large acquisition facilities for very small borrowers
  - Leakage of assets outside the group
  - Increased level of portability
  - Restrictions on transferability
- Junior debt being paid back before more-senior debt
- Increasing loan hold strategies (with large debt hold levels), thereby increasing portfolio concentration
- Higher use of fund leverage
- Lending to more cyclical industries
- Increased level of direct lending in less lender-friendly jurisdictions (Southern Europe)

[1] LCD European Leveraged Lending Review, October 2018

# Direct lending strategies: cov-lite loans

## The rise of cov-lite loans

### Cov-lite loans

- Cov-lite loans (senior loans with weaker investor protections) dominate large-cap segment of the European market
  - In 2007, cov-lite loans accounted for <10% of deals in the large-cap market. By July 2017, this figure had climbed to 72%[1]

### The value of maintenance covenants in protecting investors

- Maintenance covenants test the trading performance of borrowers. If this declines, they act as an early-warning default trigger and lenders can take protective actions. They include:
  - Increasing the yield of the loan to reflect the greater risk
  - Requiring the borrower to sell business divisions or assets to pay down the loan
  - Requiring the borrower to prioritise cash generation over corporate expansion in order to pay down the loan
  - In a worst-case scenario, enforcing the security provided in the loan

### Worsening risk-return profile of cov-lite and cov-loose

- Cov-lite loans are being proposed to less robust borrowers
- For businesses unable to trade out of their difficulties, a cov-lite deal structure will conceal and delay their inevitable defaults
- Recovery value from defaulting cov-lite loans is yet to be tested. But a comparison of recovery rates between senior loans of 74% (both covenanted and cov-lite) and first-lien secured bonds of 52% (entirely cov-lite) from 2003-2016 might provide some insight[2]
- Cov-loose: some covenanted loans have lax maintenance tests, making them ineffective as a means of protection

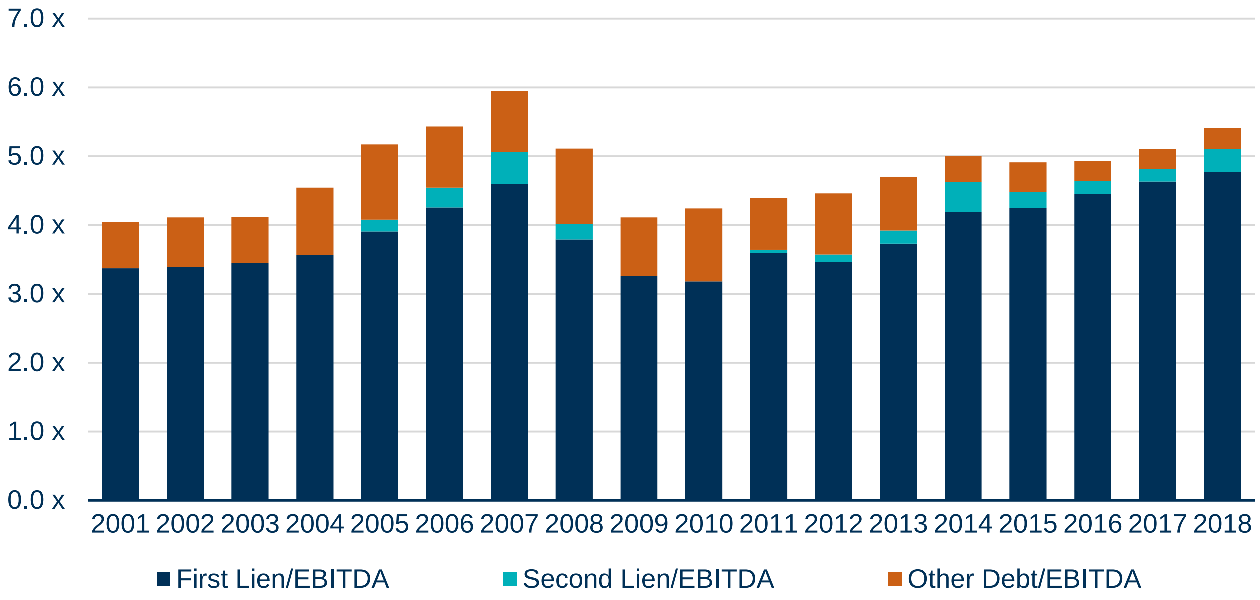
[1] "European leveraged lending review," published by LCD in July 2017.
[2] "2016 Annual Study of European Corporate Recoveries: The Highest Recovery Rate Since 2007," published by S&P Global RatingsDirect on 12 June 2017.

# Market overview

## Leverage and cash interest coverage levels

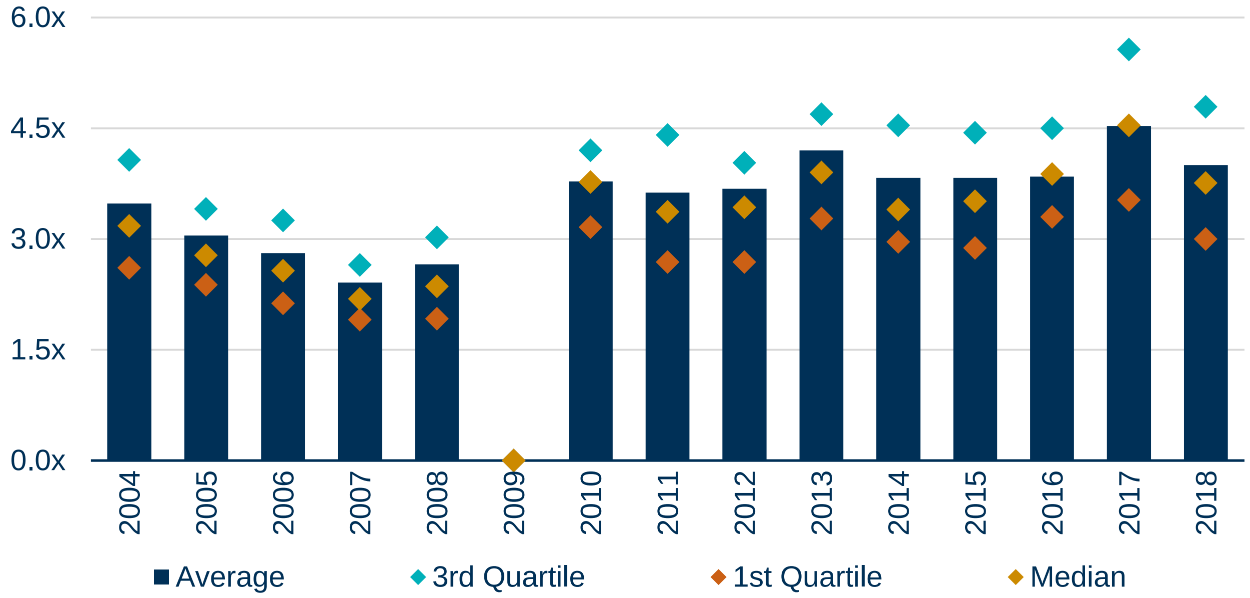
- Total leverage multiples remain in the 4.5x-5.0x range – still below peak 6.0x multiples. This is supported by:
  - High levels of equity contribution
  - Conservative EBITDA/Cash interest ratios – which are at their highest level for the past 10 years

### Average debt/EBITDA in Europe




Source: S&P Global Market Intelligence as at 31 December 2018.

### Average EBITDA/cash interest in Europe




Excludes Broadcasting, Cable & Telecom loans prior to 2002.
Includes only transactions for which Pro Forma financials were made available.

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# IMPACT OF DIFFERENT INVESTMENT PARAMETERS

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# ESG Integration

## ESG integrated into the investment process

### Why we analyse ESG risk

- ESG risks can impact investments as heavily as financial risks
  - Corporate governance and culture
  - Operational performance, labour relations and productivity
  - Sustainability of supply chains
  - Environmental impact
- Good ESG practices reduce risk and improve long-term returns, supporting our aim of preserving capital and capturing yield

### ESG scoring methodology[1]

**ESG due diligence on loan**
Fundamental research involving Hermes EOS and the Hermes Responsibility team

**Environmental analysis**
Including energy efficiency, pollution and waste management

**Social analysis**
Including workplace health and safety. Labour relations and supply-chain management,

**Governance analysis**
Including board structure, risk controls and procedures, and transparent reporting

**E score** (high risk – low risk)

**S score** (high risk – low risk)

**G score** (high risk – low risk)

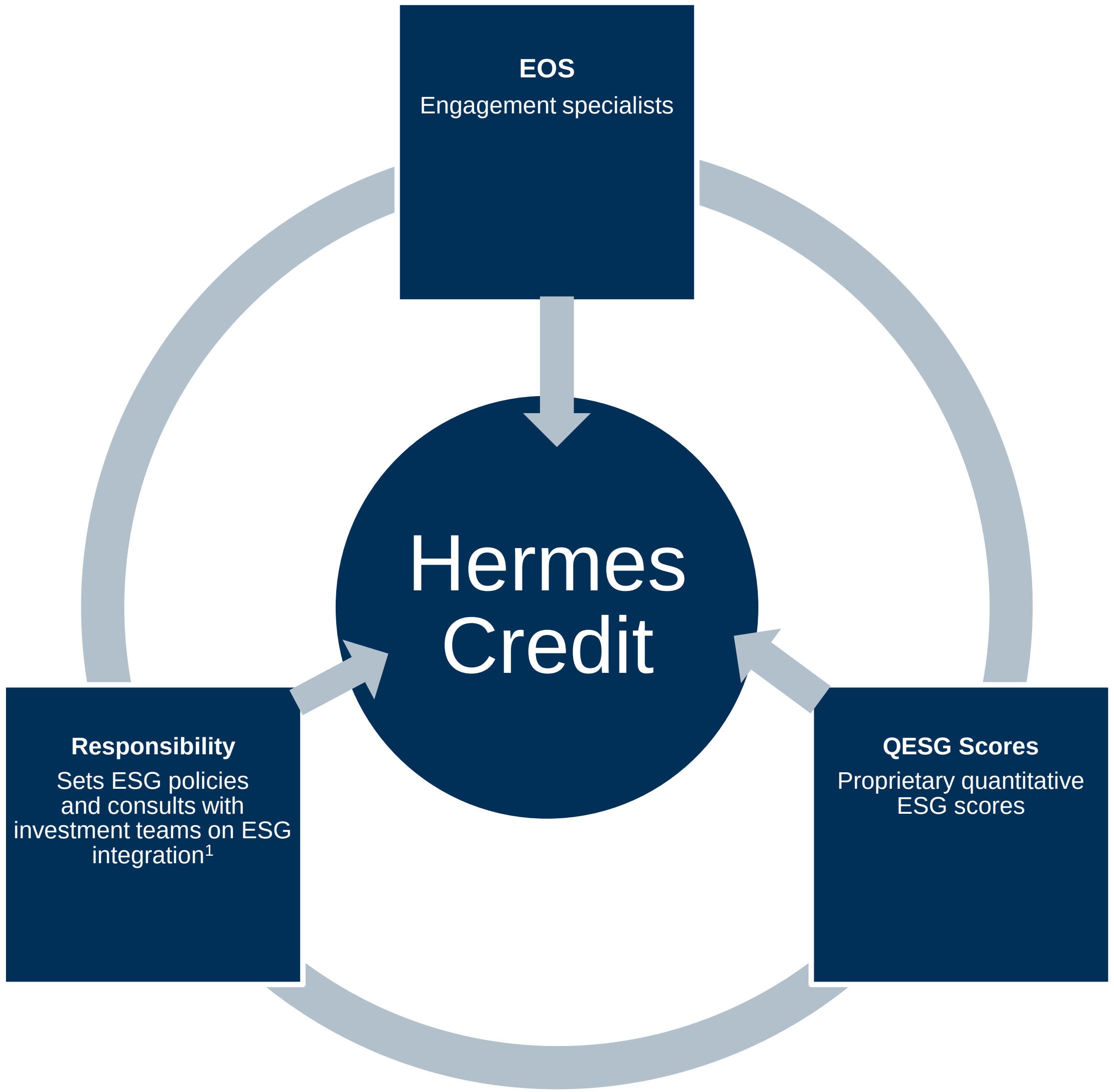
**ESG score on loan**
Weighted towards the highest E, S or G score

Source: Hermes. [1] This applies to companies that are not in our list of excluded industries. To see this list, please refer to the appendix of this presentation.

# Plethora of ESG resources under one roof

## Supports dynamic ESG Integration

- Responsibility team consults credit team on policy and integration
- Collaboration with EOS in engagement at highest of management and board levels
  - Serves to deliver holistic returns
  - Allows for "real-time" ESG analysis
- Internal, proprietary QESG scores allows for pricing of ESG risks




[1]Source: ESG research. For illustrative purposes only.

# Sponsor-backed deals

## Private Equity skin in the game – it's important!

- Equity cushion in LBO transactions
  - Continues to provide valuable cushion should a loan underperform
- Discipline among private-equity firms evident in average purchase price multiple for acquisitions
  - Provides lenders with added security in the underlying valuations of the businesses financed

**Average equity contribution [1]**

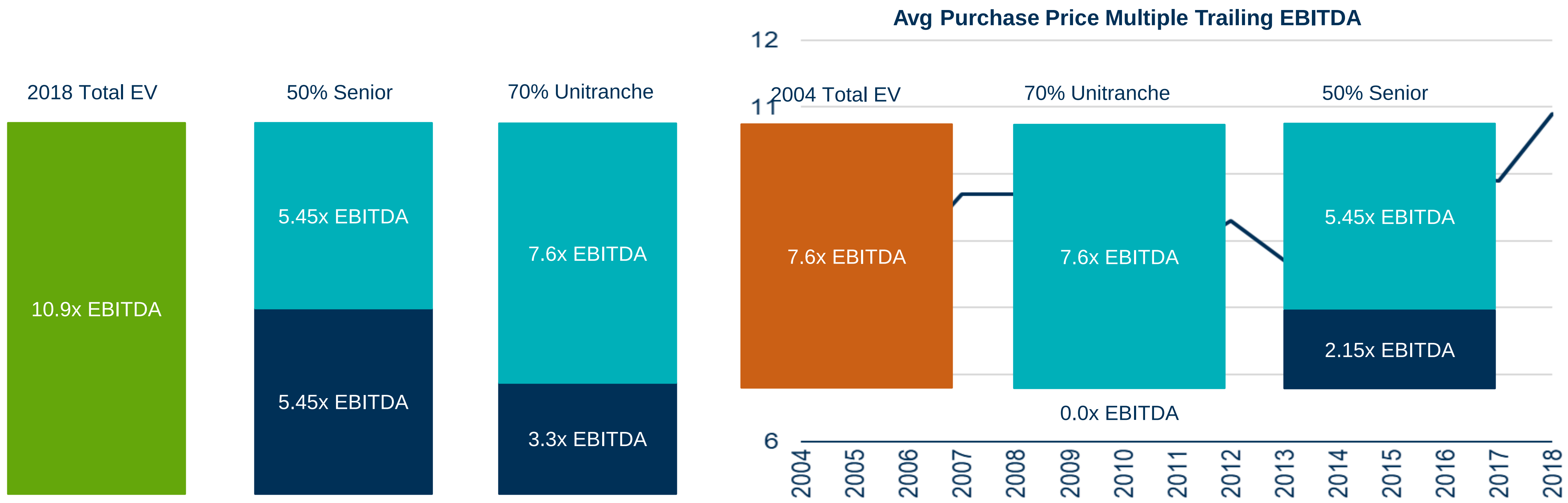
| PPM | LTM 3/31/18 | 2017 (%) | 2016 (%) | 2015 (%) | 2014 (%) | 2013 (%) | 2012 (%) | 2011 (%) | 2010 (%) | 2009 (%) | 2008 (%) | 2007 (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 5.0x to 7.9x | 40 | 41 | 43 | 38 | 39 | 40 | 49 | 44 | 43 | 51 | 46 | 33 |
| 8.0x to 9.9x | 40 | 41 | 47 | 41 | 36 | 45 | 50 | 45 | 51 | N/A | 45 | 34 |
| 10.0x to 11.9x | 44 | 44 | 54 | 46 | 45 | 44 | 54 | 53 | 55 | N/A | 45 | 33 |
| 12.0x or greater | 55 | 53 | 52 | 48 | 57 | N/A | 62 | 55 | 60 | N/A | 48 | 34 |

It is important that private equity sponsors have skin in the game in downside scenarios

Source: S&P Global Market Intelligence as at Capital IQ as at end March 2018.

# Equity cushion

## A second lien buffer can help to protect the senior piece of the loan



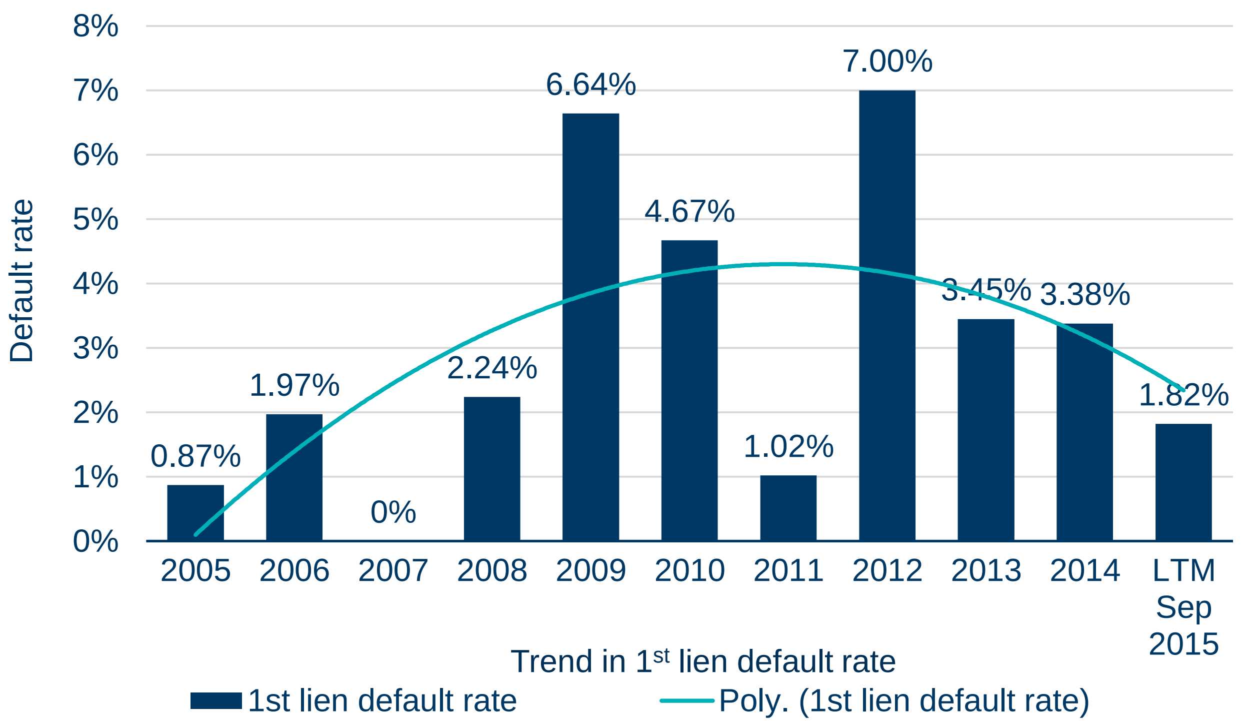

Source: Hermes, S&P Global Market Intelligence as at Capital IQ as at end YE 2018.

# Direct lending strategies: jurisdictions

## 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]**



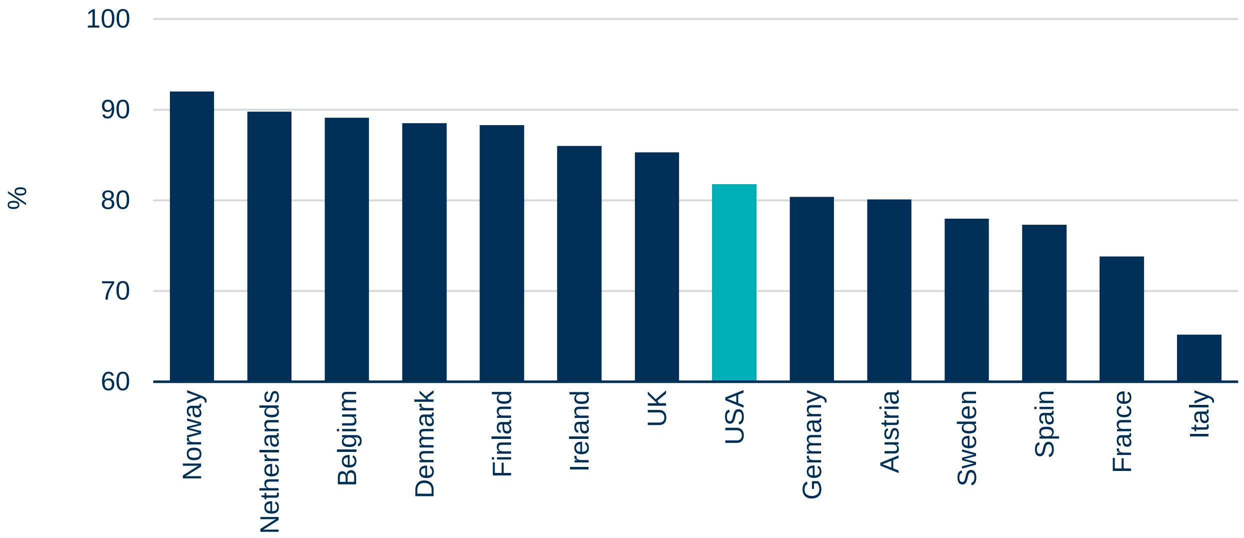

[1] Source: "Leveraged finance default review" by Jonathan Blau et al. Published by Credit Suisse Fixed Income Research, Global Leveraged Finance Strategy on 14 October 2015.
[2] "2014 European Empirical and Recovery Rating Performance Update Shows Continued Strong First Lien Recoveries", published by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

# Direct lending strategies: jurisdictions

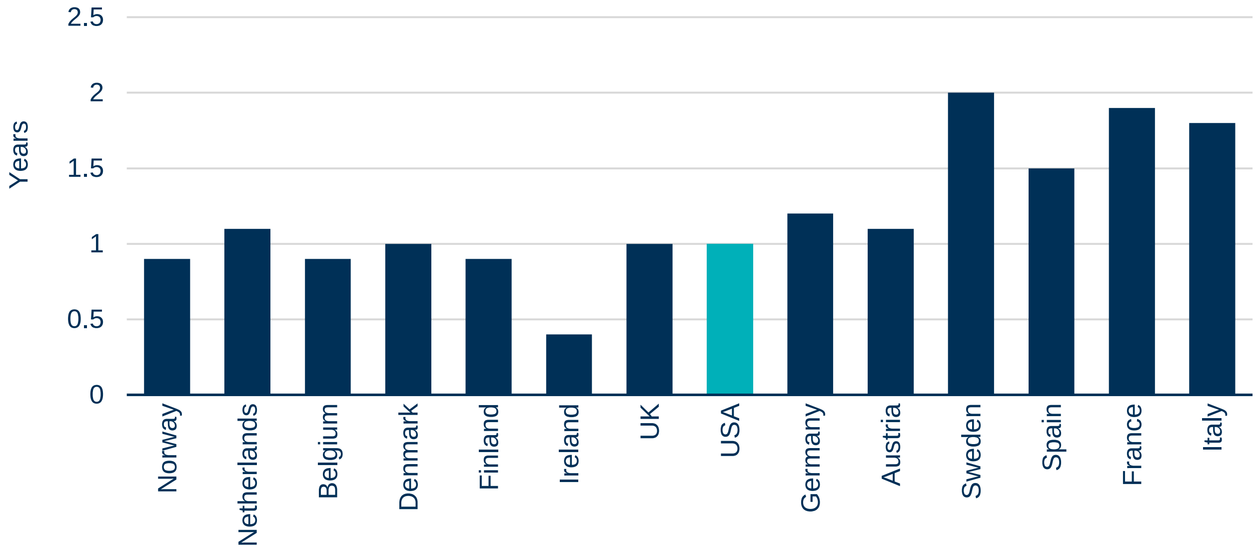
## Europe v USA: Insolvency and recovery timeframes

- 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
- Southern Europe has presented less-favourable recovery conditions. It has:
  - Lower recovery rates.
  - Longer restructuring periods.

### Recovery rates in an insolvency: Europe v USA




### Average restructuring periods: Europe v USA




The World Bank as at May 2019.

# Summary

## End-of-cycle Direct Lending

### Benefits of Direct Lending

- Attractive yield, low volatility
- High recovery rates, downside protection
- Inflation / deflation hedge

### Benefits of sponsored lending

- Equity support, professional management teams
- Equity commitments forge alignments of interest with lenders
- Superior quality of information, additional due diligence

### Process / Philosophy

- Origination strategy can impact portfolio quality
- Jurisdictional focus affects recovery rates
- ESG integration influences outcome
- Product features impact losses

### Investment Team

- Adding value through sourcing strategy
- Adding value in credit analysis and monitoring
- Adding value through experience and recovery process

**Gross Yield Fallacy … Adjust for Expected Loss**

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# HERMES DIRECT LENDING FUND

Q3 2019

For professional investors only

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# OUTCOMES BEYOND PERFORMANCE

**Our approach to holistic returns means we are committed to delivering excellent long-term investment performance and stewardship, while improving the lives of many**

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# Executive summary

## Hermes Direct Lending Fund

| | |
|---|---|
| **Clear and customisable Fund** | ► Diversified portfolio of attractive 1st lien European senior-secured and unitranche loans<br>► Customisable investment Fund<br>– **European Direct Lending (EUR)** – targeting EURIBOR + 5-6% gross annualised returns<br>– **UK Direct Lending (GBP)** – targeting LIBOR + 6% gross annualised returns<br>– Co-investment vehicle allows higher bespoke return targets<br>► Intensive fundamental credit analysis prioritising downside protection |
| **Experienced team** | ► Full spectrum of loan-investing skills<br>► Through-the-cycle experience<br>► Average of 15 years' credit experience within the Investment Team |
| **Unique origination capability** | ► Four co-lending agreements: KBC (Benelux), NatWest (UK), Danske Bank (Nordics) and DZ Bank (Germany)<br>– Exclusive access to high-quality loans to European mid-market businesses<br>– Partner banks are legally bound to invite Hermes to participate in deals<br>► Complemented by independent origination through the team's contacts in Europe |
| **Organisational strength** | ► Natural alignment of interests with investors<br>► Hermes is a significant European private equity investor with strong sponsor relationships<br>► Direct lending is a strategic growth initiative backed by significant seed capital |

Targets cannot be guaranteed.

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# HERMES INVESTMENT MANAGEMENT

Aiming to deliver excellent, long-term investment returns – responsibly

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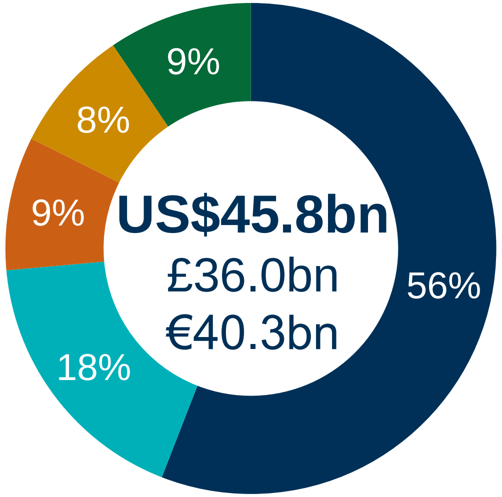
# Hermes Investment Management

## A diversified platform




| Total AUM (millions) | USD | GBP | EUR |
|---|---|---|---|
| Equity | 25,630 | 20,138 | 22,507 |
| Real Estate | 8,099 | 6,364 | 7,112 |
| Infrastructure | 4,033 | 3,169 | 3,541 |
| Fixed Income | 3,732 | 2,932 | 3,277 |
| Private Equity | 4,347 | 3,416 | 3,818 |

**508** STAFF

Located in:


**US$637.8bn**

£501.1bn / €560.0bn

Under stewardship

**219**

**Investment and stewardship staff**

Please note the total AUM figure includes US$8.4bn / £6.6bn / €7.4bn 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. US$30.0m / £23.6m / €26.4m of total group AUM figure represents HFM mandates under advice. Source: Hermes as at 30 June 2019.

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# CHARACTERISTICS

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# Hermes Direct Lending Strategy European Fund

## Seeking attractive and stable returns from high-quality senior loans, while offering the flexibility to target higher yields

| Key Characteristics | EUR Fund |
|---|---|
| **Performance objective** | EURIBOR + 5-6% on a gross annualised basis[1] |
| | Co-investment vehicle allows for higher bespoke return targets |
| **Universe** | Senior loans to European mid-market businesses |
| | – European loans: >65%<br>– UK loans: up to 35% |
| **Eligible instruments** | Senior-secured loans: ≥65%<br>Unitranche loans: up to 35% |
| **Management fee** | 75bps on NAV |
| **Performance fee** | 10% of returns exceeding EURIBOR + 3.5% net per annum, compounded annually |
| | Calculated when all loans in the portfolio have been repaid |
| **Maximum industry concentration** | Maximum of 20% of portfolio in any industry (with any two at 25%) |
| **Base currency** | Euros, with hedging on foreign currency exposure |
| **Investment Period** | 3.5 years post First Closing, with the ability to extend by 1 year with Investor Committee consent |
| **Investment Term** | 7 years from Final Closing, with the ability to extend by 2 years with investor consent |
| **Concentration** | Highly diversified pool of loans |

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. Any investments overseas may be affected by currency exchange rates. Past performance is not a reliable indicator of future results and targets are not guaranteed.

[1] This return target has been revised upwards from that stated in the product offering document.

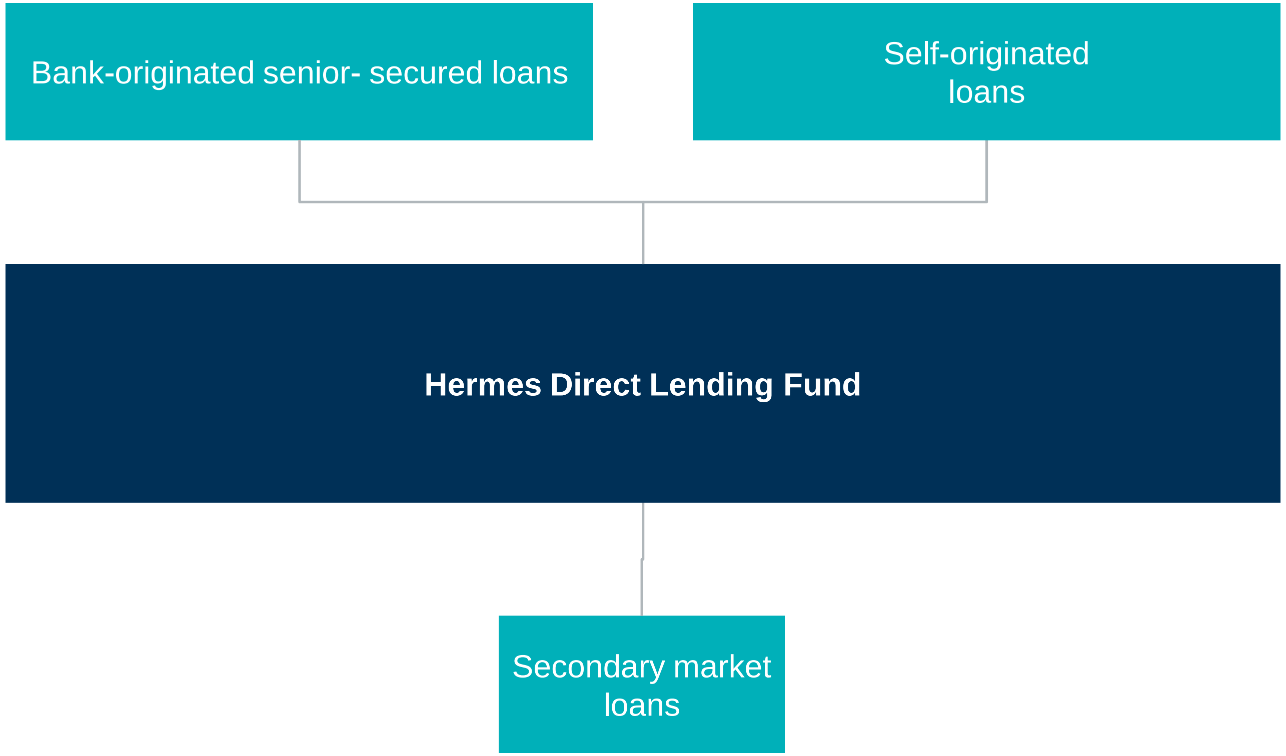
# Hermes Direct Lending Fund

## Desired loan characteristics

### Key transaction features

| | |
|---|---|
| **Company profile** | ► First-class sponsor or shareholder<br>► European SME focus<br>− EBITDA ranging from €5m to €75m<br>− Enterprise value ranging from €50m to €750m<br>► Leverage below 5.5x for senior-secured loans<br>► Covenant package and first-ranking securities<br>► No cov-lite instruments |
| **Eligible instruments** | ► Senior loans<br>– Preferably ‘club’ deals<br>► Unitranche loans<br>► Equity owned only as a result of restructuring |
| **Key terms** | ► 1st lien loans<br>► Term loan B – bullet repayment<br>► Typical maturity of 6-8 years<br>► No rating constraints |

### Investment universe

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# Hermes Direct Lending Platform

| | | | | |
|---|---|---|---|---|
| Covidence (miniature surveillance solutions) | Surveillance Solutions | July 2019 | Leveraged Buyout, Senior Secured | Denmark |
| LAP Laser | Laser Measuring Solutions | July 2019 | Secondary Buyout, Senior Secured | Germany |
| European Sperm Bank | Human Health | April 2019 | Leveraged Buyout, Senior Secured | Denmark |
| Sports & Leisure Group | Artificial Grass Manufacture | January 2019 | Add-on Facility, Senior Secured | Belgium |
| Carsoe | Food Processing Equipment | January 2019 | Leveraged Buyout, Senior Secured | Denmark |
| DEAS | Property Management | November 2018 | Refinance/Recapitalisation, Senior Secured | Denmark |
| ByBox | Supply Chain Technology | August 2018 | Secondary MBO, Senior Secured | United Kingdom |
| Law Business Research | Legal Analysis Publisher | July 2018 | Add-on Facility, Senior Secured | United Kingdom |
| Law Business Research | Legal Analysis Publisher | March 2018 | Secondary Buyout, Senior Secured | United Kingdom |
| Datix (Software for patient safety) | Healthcare Software | November 2017 | Add-on facility, Senior Secured | United Kingdom |
| Key Retirement | Consumer Finance | July 2017 | Leveraged Buyout, Senior Secured | United Kingdom |
| Datix (Software for patient safety) | Healthcare Software | May 2017 | Add-on facility, Senior Secured | United Kingdom |
| Morrison Utility Services | Utility Services | February 2017 | Add-on Facility, Senior Secured | United Kingdom |
| Kingsbridge Contractor Insurance | Insurance Brokerage | November 2016 | Recapitalisation, Senior Secured | United Kingdom |
| Equiom | Wealth Services | November 2016 | Add-on Facility, Senior Secured | United Kingdom |
| Tilney Bestinvest | Wealth Management | November 2016 | Leveraged Buyout, Senior Secured | United Kingdom |
| JLA | Commercial Cleaning | September 2016 | Leveraged Buyout, Senior Secured | United Kingdom |
| photoboxgroup | Digital Printing | September 2016 | Leveraged Buyout, Senior Secured | United Kingdom |
| Morrison Utility Services | Utility Services | September 2016 | Leveraged Buyout, Senior Secured | United Kingdom |
| ByBox | Supply Chain Technology | August 2016 | Leveraged Buyout, Senior Secured | United Kingdom |

Source: Hermes as at July 2019.

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# INVESTMENT TEAM AND PROCESS

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# Investment team

## Expert team with institutional support

**Patrick Marshall**
Head of Private Debt & CLOs

| **Laura Vaughan, CFA** | **Alexandra Trapes** | **Maria van der Veer** | **Carina Spitzkopf** | **Kevin Roche** |
|---|---|---|---|---|
| Head of Direct Lending | Director | Director | Director | Director |

**Hermes Credit**
**Mitch Reznick,** CFA
Co-Head and Head of Research, plus 5 analysts

**Providing research on industry sectors:**

- Financials
- Energy
- Utilities
- Healthcare
- Automotive
- Retail and leisure

**Team characteristics**

**Experience**

- Core team of 6 investment professionals with an average of 15 years' experience[1]
- Experience at leading mid-market lending institutions and in European credit markets
- Invested in loans throughout the full extent of credit cycles

**Credit-focussed investing**

- Intensive bottom-up credit analysis
- Focus on high-quality instruments, not chasing yield
- Conservative investment style provides downside protection
- Monitoring investments is equally as important as execution

**Full range of loan-investing skills**

- Strategic origination agreements with lenders
- Independent origination through extensive contacts
- Structuring, execution, monitoring, restructuring, work-out
- Hermes GPE enhances firm's reputation among sponsors

**Alignment of interests with investors**

- Substantial seed investment from parent shareholder
- Remuneration linked with returns to clients
- Hermes Investment Office independently reviews performance

**Organisational support**

| Legal | Hermes Investment Office | Operations |
|---|---|---|

Source: Hermes as at 31 July 2019.

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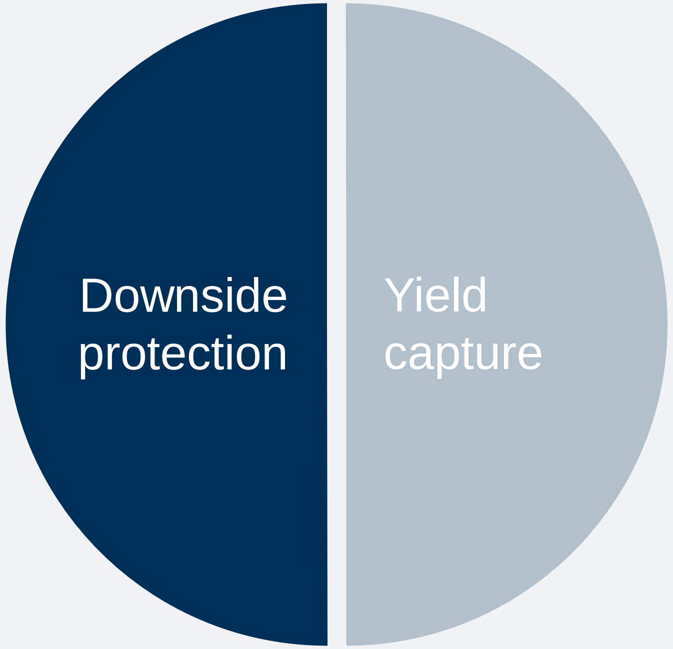
# Investment process

## Investment philosophy

### Return of capital is more important than return on capital

- Aiming for capital preservation coupled with yield capture
  - Return of capital has primacy over additional yield
- Proactive, fundamental, bottom-up research
- Focus on defensive characteristics:
  - High barriers to entry
  - Resilient and diversified cash flows
  - Established and experienced management teams
- Prescriptive loan documentation maximises protection and establishes controls over borrowers
- Independent due diligence
- Floating-rate coupons hedge the impact of rising interest rates
- Active management and portfolio monitoring




- Buy-and-hold investment approach
  - Flexibility to invest in senior-secured and unitranche loans, aiming to maximise investment and yield opportunities
- Yield capture driven by contractual performance
  - Outperformance driven by minimising defaults and maximising recoveries
- Constant assessment of the relative value of new opportunities

# Investment process

## Overview

Origination → Company evaluation → Transaction structure → Monitoring → Exit

### Origination

- Loans sourced through bank co-lending agreements:
  - KBC Bank
  - Danske Bank
  - NatWest
  - DZ Bank
- Self-origination through market contacts:
  - Financial intermediaries
  - Sponsors
  - Banks
  - Corporate treasurers
- Secondary acquisitions when favourable yields are available

### Company evaluation

- Fundamental bottom-up analysis: business risk, financial risk, structural risk
- Review of third-party due diligence
- Meetings with management

### Transaction structure

- Risk-return analysis, including comparison of relative value
- Evaluation of capital structure, security package and legal arrangements, including loan documentation
- Review of 'club' or other participants in transactions
- Transaction fees given to the strategy

### Monitoring

- Measuring borrowers' performance against expectations, with in-depth review discussions with management teams
- Assess compliance with covenants and assumptions in recovery analysis
- Manage any impaired loans and defaults

### Exit

- Repayment or refinancing
- Sale or restructuring of underperforming assets with an understanding of market dynamics and liquidity of the underlying loan

# Investment process

## Origination strategy

| Transaction type | Sourcing | Transaction strategy | Targeted return |
|---|---|---|---|
| European senior-secured loans | ▶ Origination agreements with European banks:<br>– KBC Bank<br>– Danske Bank<br>– Royal Bank of Scotland/NatWest<br>– DZ Bank | ▶ Co-lending agreement provides transaction volume<br>▶ Lender of record in bank-originated transactions<br>▶ Input on structure and pricing<br>▶ Independent credit analysis and asset selection | >4% |
| Corporate and European private debt | ▶ Sponsors<br>▶ Debt advisory groups<br>▶ Banks<br>▶ Corporate management teams | ▶ Self-origination with an aim to enhance yield<br>▶ UK corporate and pan-European senior-secured loans<br>▶ UK and pan-European unitranche loans<br>▶ Higher yields for bespoke financing solutions | 5-8% |
| Secondary loans | ▶ Banks<br>▶ Debt funds<br>▶ Independent brokers | ▶ Broad investment universe<br>▶ Access to partner banks' back books<br>▶ Relative-value positioning<br>▶ Focus on high-performing instruments | 3-5% |

Our co-lending partnerships with leading banks, combined with our own origination skills, sustain a strong pipeline of high-quality loans

Targets cannot be guaranteed.

# Investment process

## Strong origination through exclusive co-lending agreements

**Danske Bank**
- #1 SME lender in Denmark
- #2 SME lender in Sweden & Finland
- #3 SME lender in Norway

**KBC Bank**
- #1 SME lender in Belgium
- #2 SME lender in Luxembourg
- #5 SME lender in the Netherlands

**NatWest**
- #2 SME lender in the UK
- #3 SME lender in Ireland (through Ulster bank)

**DZ Bank**
- #3 SME lender in Germany

**Key terms**
- Formal agreements providing Hermes with exclusive access to high-quality loans
- Partner banks are legally bound to invite Hermes to participate in deals
- Hermes exercises full discretion over which loans it invests in

Source: Danske Bank, DZ Bank, NatWest and KBC Bank as at July 2017. GCA Altium MidCapMonitor Q4 2016.

# Investment process

## Fundamental analysis

### Economic and industry

- Macroeconomic view and jurisdictional risks
- Market position and location in the value chain
- Industry dynamics, including cyclical and regulatory issues
- Product and business analysis, including barriers to entry

### Company evaluation

- Strategy and future growth prospects
- Management team experience and depth
- Profitability and cash flow sustainability and diversification
- Balance sheet stability
- Capital structure
- Going concern valuation and break up value
- Ownership and track record of sponsor

### Structural considerations

- Key terms of the proposed loans
- Eligibility and relative-value analysis
- Proposed security package
- Jurisdictional matters

### Receive loan request

- Prepare screening paper
- Identify key risks
- Present loan terms

**1st Investment Committee meeting**

### Fundamental credit analysis

- Business risk
- Financial and legal risk
- Structural analysis
- Loan terms
- Model, projections and stress analysis
- Eligibility criteria and relative-value analysis
- Management and due diligence meetings

**2nd Investment Committee meeting**

### Final review

- Review loan terms
- Review legal documentation
- Address all outstanding points raised at Investment Committee

**Board approval**

**Investment**

# Investment process

## Monitoring process

### Monitoring and managing loans is equally as important as the initial investments

- Track underlying performance of borrowers against expectations
- Relative value of loans against similar instruments

**Deal pipeline**

Consists of potential investments nominated by analysts. All actions regarding the instruments and underlying borrowers are subject to Investment Committee approval

**Daily monitoring**
- News flow
- Company-specific and industry developments

**Weekly monitoring**
- Pipeline review and market conditions
- New investment activity
- Review watch list and other material credit issues

**Monthly monitoring**
- Monthly accounts versus expectations and annual performance
- Review of KPIs, covenant headroom and liquidity
- Management meetings if necessary

**Quarterly portfolio review**
- Formal review of all portfolio instruments
  - Changes in business fundamentals and management
  - Review of performance to date and forecasts for underlying borrowers
  - Portfolio diversification
- Review of watch list – course of action agreed
- Recovery analysis on all work out credits, and review of work-out strategy

# Investment process

## Work-out and restructuring expertise

### Investment team is experienced in loan restructuring and work-outs across Europe

Contacts among lawyers, restructuring advisors, accountants, and the restructuring units of major banks and distressed-debt funds

**Portfolio Manager led the restructuring team in Europe and Asia for Lehman Brothers prior to its bankruptcy**

**Media (Netherlands)**
Steering Committee

**Hospitality company (UK)**
Bilateral

**Steel company (UK)**
Advisor to Syndicate

**Financial services company (UK)**
Bilateral

**Telecoms company (Germany)**
Steering Committee

**Specialist packaging company (Germany)**
Advisor to Syndicate

**Meat packaging company (Netherlands)**
Advisor to Syndicate

**Financial institution (Austria)**
Steering Committee

**Petrol station operator (Belgium)**
Advisor to Syndicate

**Financial institution (Sweden/Iceland)**
Chair, Steering Committee

**Telecoms company (Spain)**
Advisor to Syndicate

**Other transactions**
Business directory (Italy), Industrial (Netherlands), gambling (UK), entertainment (UK), motoring services (UK), media (UK), heavy manufacturing (Germany), retail (France), construction (Denmark), chemical (Hungary), aircraft loans (USA), resources (Ghana and Kyrgyzstan), conglomerate (Saudi Arabia and Switzerland) and a number of Russian loans

Portfolio Manager oversaw the work-out of the Lehman Brothers European corporate and real estate loan portfolio

Source: Hermes.

# Investment process

## ESG integration

### Why we analyse ESG risk

- ESG risks can impact investments as heavily as financial risks
  - Corporate governance and culture
  - Operational performance, labour relations and productivity
  - Sustainability of supply chains
  - Environmental impact
- Good ESG practices reduce risk and improve long-term returns, supporting our aim of preserving capital and capturing yield

### ESG scoring methodology[1]

**ESG due diligence on loan**
Fundamental research involving Hermes EOS and the Hermes Responsibility team

**Environmental analysis**
Including energy efficiency, pollution and waste management

**Social analysis**
Including workplace health and safety. Labour relations and supply-chain management,

**Governance analysis**
Including board structure, risk controls and procedures, and transparent reporting

**E score** (high risk – low risk)

**S score** (high risk – low risk)

**G score** (high risk – low risk)

**ESG score on loan**
Weighted towards the highest E, S or G score

Source: Hermes. [1] This applies to companies that are not in our list of excluded industries. To see this list, please refer to the appendix of this presentation.

HERMES
INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

# SUMMARY

HERMES
INVESTMENT MANAGEMENT

# Executive summary

## Hermes Direct Lending Fund

| | |
|---|---|
| **Clear and customisable Fund** | ► Diversified portfolio of attractive 1st lien European senior-secured and unitranche loans<br>► Customisable investment Fund<br>– **European Direct Lending (EUR)** – targeting EURIBOR + 5-6% gross annualised returns<br>– **UK Direct Lending (GBP)** – targeting LIBOR + 6% gross annualised returns<br>– Co-investment vehicle allows higher bespoke return targets<br>► Intensive fundamental credit analysis prioritising downside protection |
| **Experienced team** | ► Full spectrum of loan-investing skills<br>► Through-the-cycle experience<br>► Average of 16 years' credit experience within the Investment Team |
| **Unique origination capability** | ► Four co-lending agreements: KBC (Benelux), NatWest (UK), Danske Bank (Nordics) and DZ Bank (Germany)<br>– Exclusive access to high-quality loans to European mid-market businesses<br>– Partner banks are legally bound to invite Hermes to participate in deals<br>► Complemented by independent origination through the team's contacts in Europe |
| **Organisational strength** | ► Natural alignment of interests with investors<br>► Hermes is a significant European private equity investor with strong sponsor relationships<br>► Direct lending is a strategic growth initiative backed by significant seed capital |

Targets cannot be guaranteed.

OUTCOMES BEYOND PERFORMANCE

# APPENDIX

# Sponsor-backed deals

## High average multiples paid for businesses

**Average purchase price multiple**

| Year | All buyouts | Secondary buyout | Corporate divestiture | Public to private |
|---|---|---|---|---|
| 2004 | 7.6x | 7.3x | 7.5x | 7.4x |
| 2005 | 8.3x | 8.6x | 7.7x | 8.7x |
| 2006 | 8.8x | 8.8x | 8.2x | 9.8x |
| 2007 | 9.7x | 10.4x | 9.0x | 10.4x |
| 2008 | 9.7x | 9.9x | 9.0x | 10.3x |
| 2009 | 8.9x | N/A | 9.9x | N/A |
| 2010 | 9.2x | 9.7x | 7.4x | N/A |
| 2011 | 8.8x | 8.8x | 8.6x | N/A |
| 2012 | 9.3x | 9.4x | 8.7x | N/A |
| 2013 | 8.7x | 9.0x | 8.0x | 8.7x |
| 2014 | 9.7x | 9.8x | 9.3x | 8.7x |
| 2015 | 9.2x | 8.9x | 9.9x | 10.7x |
| 2016 | 10.0x | 9.7x | 8.4x | 12.8x |
| 2017 | 10.3x | 10.6x | 8.9x | 9.4x |
| LTM 31/03/2018 | 10.3x | 10.6x | 9.4x | 9.3x |

Source: S&P Global Market Intelligence as at Capital IQ as at end March 2018.

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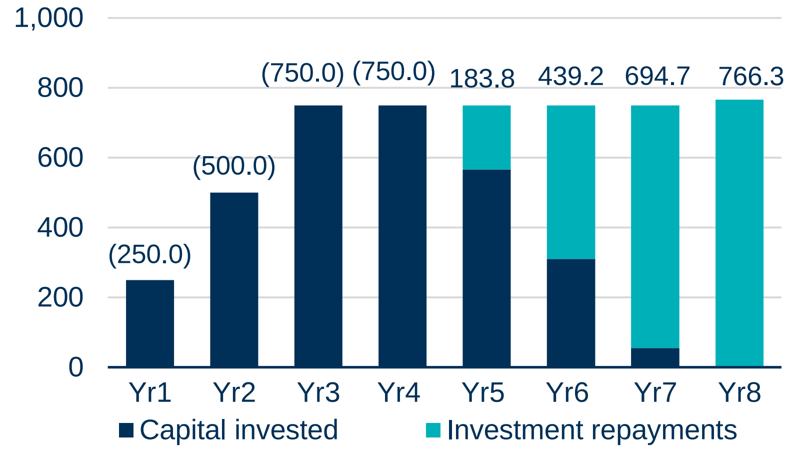
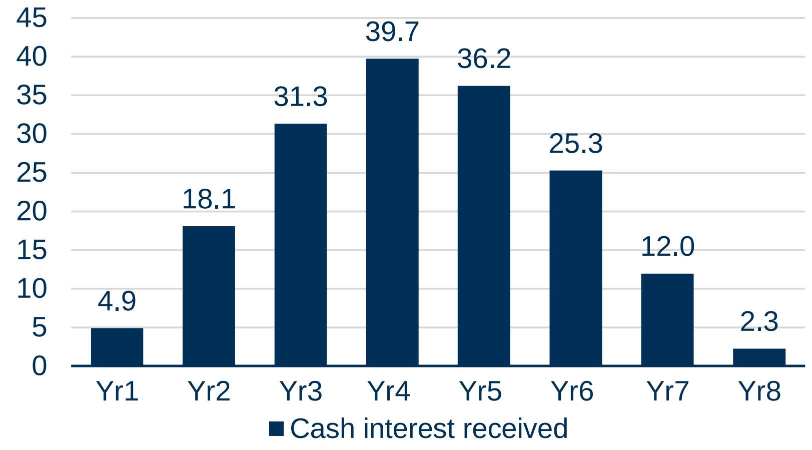
# Hermes UK Direct Lending: illustrative cash flows

| (in £m) | Total | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 |
|---|---|---|---|---|---|---|---|---|---|
| Capital invested | (750) | (250) | (250) | (250) | | | | | |
| Arrangement fees | 18.6 | 6.2 | 6.2 | 6.2 | | | | | |
| Cash interest received | 169.7 | 4.9 | 18.1 | 31.1 | 39.7 | 36.2 | 25.3 | 12 | 2.3 |
| Investment repayments | 766.3 | 0 | 0 | 0 | 0 | 183.8 | 255.4 | 255.4 | 71.7 |
| Opening cash | | 0 | (238.9) | (464.6) | (677.1) | (637.4) | (417.4) | (136.7) | 130.7 |
| Gross cash flow | | (238.9) | (225.7) | (212.5) | 39.7 | 220 | 280.7 | 267.4 | 73.9 |
| Closing cash | | (238.9) | (464.6) | (677.1) | (637.4) | (417.4) | (136.7) | 130.7 | 204.6 |

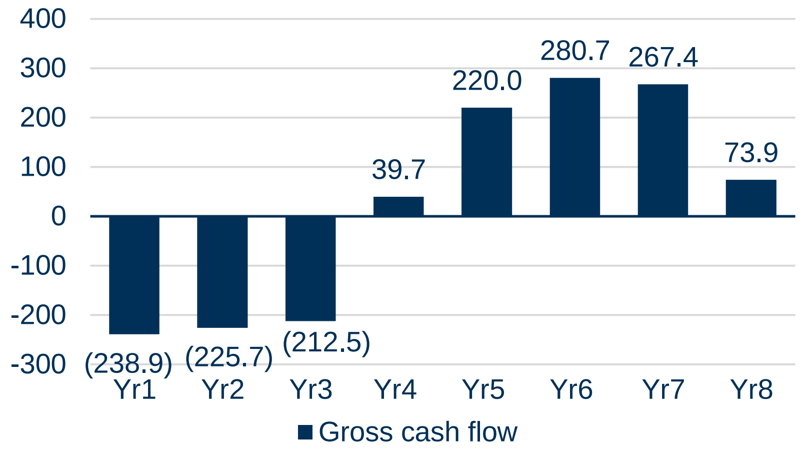
### Capital invested and repaid (£m)[1]




### Interest and fee income (£m)




### Fund gross cash flow (£m)



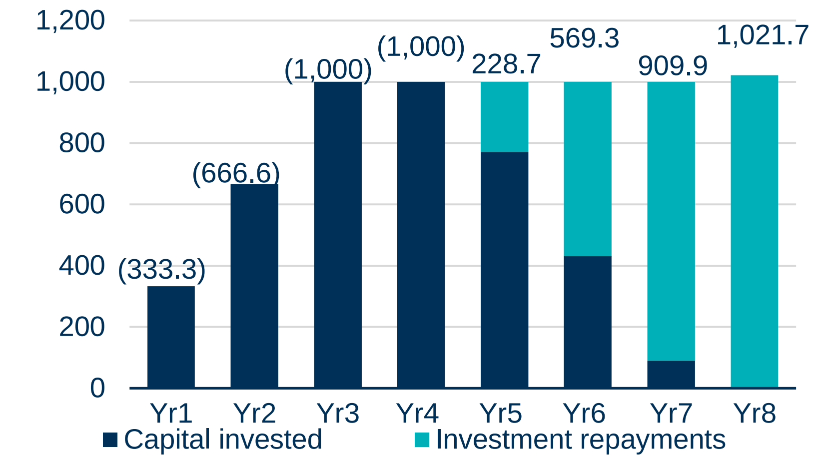

| Fund term assumptions | | Senior loan assumptions | | Unitranche assumptions | |
|---|---|---|---|---|---|
| Fund size: | £750,000,000 | Expected % of total: | 75% | Expected % of total: | 25% |
| Management fee: | 0.75% | Arrangement fee: | 2.14% | Arrangement fee: | 3.50% |
| Performance fee: | 10% over L + 4.50% | Loan margin: | L + 4.75% | Current loan margin: | L + 4.00% |
| Upfront fee: | £750,000 | 3m GBP LIBOR: | 0.5000% | 3m GBP LIBOR: | 0.5000% |
| Admin cost: | 0.03% | Loan maturity: | 4.0 years | Loan maturity: | 5.0 years |
| | | LIBOR floor: | 0.00% | LIBOR floor: | 1.00% |
| | | | | PIK rate: | 3.50% |

For illustrative purposes only. Cash flows cannot be guaranteed. [1] Payment-in-Kind interest included in investment repayments.

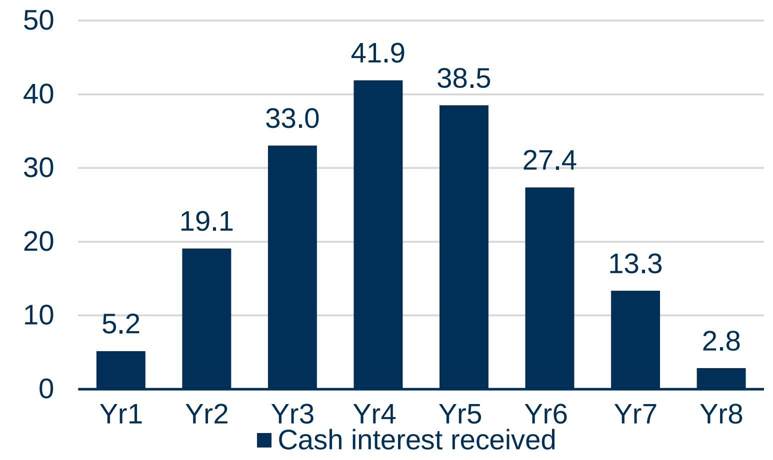
# Hermes European Direct Lending: illustrative cash flows

| (in €m) | Total | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 |
|---|---|---|---|---|---|---|---|---|---|
| Capital invested | (1,000.0) | (333.3) | (333.3) | (333.3) | | | | | |
| Arrangement fees | 25.7 | 8.6 | 8.6 | 8.6 | | | | | |
| Cash interest received | 181.2 | 5.2 | 19.1 | 33.0 | 41.9 | 38.5 | 27.4 | 13.3 | 2.8 |
| Investment repayments | 1,021.7 | 0.0 | 0.0 | 0.0 | 0.0 | 228.7 | 340.6 | 340.6 | 111.8 |
| Opening cash | | 0.0 | (319.6) | (625.3) | (917.0) | (875.1) | (607.9) | (240.0) | 113.9 |
| Gross cash flow | | (319.6) | (305.7) | (291.7) | 41.9 | 267.2 | 367.9 | 353.9 | 114.7 |
| Closing cash | | (319.6) | (625.3) | (917.0) | (875.1) | (607.9) | (240.0) | 113.9 | 228.6 |

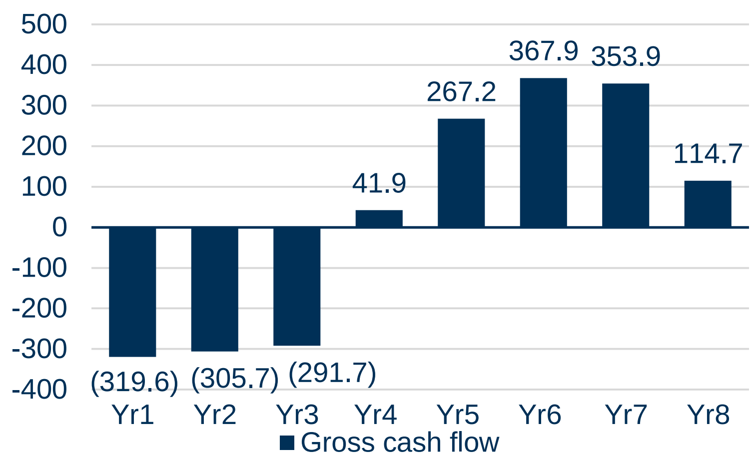
## Capital invested and repaid (€m)[1]




## Interest and fee income (€m)




## Fund gross cash flow (€m)




| Fund term assumptions | | Senior loan assumptions | | Unitranche assumptions | |
|---|---|---|---|---|---|
| Fund size: | €1,000,000,000 | Expected % of total: | 70% | Expected % of total: | 30% |
| Management fee: | 0.75% | Arrangement fee: | 2.17% | Arrangement fee: | 3.50% |
| Performance fee: | 10% over E + 3.50% | Loan margin: | E + 4.15% | Current loan margin: | E + 4.00% |
| Upfront fee: | €750,000 | 3m EURIBOR: | 0.000% | 3m EURIBOR: | 0.000% |
| Admin cost: | 0.03% | Loan maturity: | 4.0 years | Loan maturity: | 5.0 years |
| | | EURIBOR floor: | 0.00% | EURIBOR floor: | 0.00% |
| | | | | PIK rate: | 3.00% |

For illustrative purposes only. Cash flows cannot be guaranteed. [1] Payment-in-Kind interest included in investment repayments.

HERMES
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# Hermes Direct Lending: RoC considerations

## Offering a higher RoC than other assets that insurers typically invest in

| Asset class | Duration | Indicative Return[1,4,6] | Indicative Capital Charge[6] | Return on Capital[1,4,6] |
|---|---|---|---|---|
| Hermes notional Direct Lending fund – legal maturity[2] | 4.3 years | 5.5% | 12.7% | 43.3% |
| Hermes notional Direct Lending fund – average maturity[3] | 3.5 years | 5.5% | 12.2% | 45.1% |
| A rated corporate bond | 3.6 years | 1.8% | 5.0% | 35.5% |
| BBB rated corporate bond | 3.4 years | 2.6% | 8.5% | 30.3% |
| Equity (Type 1) | -- | 7.0% | 32.66%[5] | 21.4% |
| Equity (Type 2) | -- | 7.0% | 42.66%[5] | 16.4% |

Sources: Market data, Markit, Hermes.
[1] Target returns based on £108 million portfolio of 10 senior secured loans within Hermes' direct lending portfolio as of 11 January 2019.
[2] "Legal maturity" assumes that loans are held to maturity.
[3] "Average maturity" assumes that loans are held for 3.5 years.
[4] Neither indicative returns, nor stated Returns on Capital ("RoC"), nor future performance of any kind can be guaranteed.
[5] The equity capital charges (Type 1 and Type 2) include a symmetric adjustment which was -6.34% on 31 December 2018.
[6] Calculated on Hermes' assumptions of Solvency II requirements as of 11 January 2019.

# Hermes Direct Lending Fund

## ESG guidelines

**Excluded industries**

- Gambling, casinos, tobacco, alcohol, pornography
- Weapons and munitions, including cluster bombs
- Genetically modified organisms, the fur trade and cosmetic products tested on animals
- Ship breaking, shark finning and other destructive fishery practices
- Businesses damaging primary or tropical forests, wetlands and critical natural habitats

**Areas requiring enhanced due diligence**

- Due diligence involves greater contributions from the Hermes Responsibility team and Hermes EOS as appropriate:
  - Energy: oil and gas and power generation
  - Chemicals
  - Forestry and agricultural commodities
  - Manufacturing
  - Mining and metals

Source: Hermes Private Debt & Direct Lending's Environmental, Social and Governance Guidelines.

# Hermes Investment Office

## Acting in the interests of clients

**Investment teams supported by a robust and transparent risk framework**

| Responsible for delivering investment performance | Clear and independent philosophies and processes | Remuneration aligned with long-term performance | Aligned with clients' interests |
|---|---|---|---|

**Hermes Investment Office**

- Ensuring managers are always acting in clients' interests
- Objectively challenging managers' positions and views
- Providing independent performance and risk oversight
- Promoting a focus on risk-adjusted returns

# Senior-secured loans

## Top of the capital structure with attractive yield

- Classic 1st lien debt
- Historically a banking product

**Target IRR**
5.0%-6.0%

**Fees +**
**cash coupon**
4.5%-5.5%

**EURIBOR**
**(+ possible floor)**

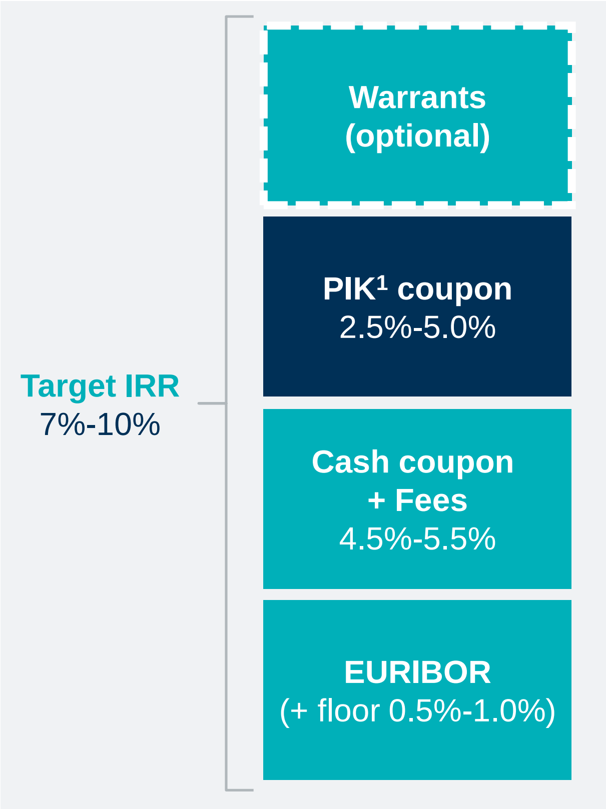
| | |
|---|---|
| Expected returns | 4.0%-5.5% |
| Key investment criteria | Capacity to reimburse the debt / LTV |
| Terms | Cash coupon: EURIBOR (+ potential floor 0%-0.5%) + margin 3.0%-5.0% |
| Security | 1st ranking |
| Value creation | Interest received + nominal repaid |
| Arranging/ underwriting fees | 2.0%-3.5% upfront or offers in discount in case of syndication |
| Usual main features | 4-7 years<br>Amortising and bullet |

For illustrative purposes only. Targets cannot be guaranteed.

# Unitranche loans

## Bespoke instruments providing strong returns

- Blending of the entire debt financing tranches into a single tranche combining senior and subordinated debt




| | |
|---|---|
| Expected returns | 6.5%-9.0% (including warrants) |
| Key investment criteria | Capacity to reimburse the debt / LTV, Capex and acquisition strategy |
| Terms | ***Cash coupon***: EURIBOR ( with floor 0.5%-1.0%) + margin 3.5%-5.0% & ***Potential PIK***: 2.5%-5.0% + Warrants (optional) |
| Security | 1st ranking |
| Value creation | Interests received + nominal repaid [+ warrants] |
| Arranging/ underwriting fees | 2.5%-3.5% |
| Usual main features | 6-8 years<br>Non-call for 2 years<br>Bullet debt |
| Involvement in management of the companies | Observer seat |

[1] Payment in kind. For illustrative purposes only. Targets cannot be guaranteed.

HERMES
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# Private Debt team

## Biographies

### Patrick Marshall

Head of Private Debt & CLOs, Senior Portfolio Manager and Member of the Investment Committee

Patrick joined Hermes in June 2015 to launch and manage the Hermes Direct Lending Strategy, which invests in senior loans to UK and European mid-market businesses. In this role, Patrick is responsible for the day-to-day management of the Hermes Direct Lending Funds and has ultimate authority on which transactions to put forward for investment by the fund, subject to Investment Committee approval. He was previously Head of Direct Lending in London at Tikehau Capital, and Partner at WCAS Fraser Sullivan Investment Management, where he established the firm’s European loan business. Prior to that, Patrick managed loan portfolios in excess of $4bn and $10bn as managing director at the Lehman Brothers Estate and head of European and Asian loan portfolio management and restructuring at Lehman Brothers respectively. He has a Bachelor of Commerce in Business Administration and French from the University of Edinburgh.

### Stephane Michel, CFA

Senior Portfolio Manager

Stephane joined Hermes in April 2018 as Senior Portfolio Manager. He is assisting the development of the multi-asset credit offering, with particular focus on the illiquid and unrated universe. Stephane has extensive credit experience, having worked both on the buy-side and sell-side. Prior to joining Hermes he was a consultant for institutions exploring portfolio transactions, risk transfer trades and establishing asset management platforms. Previously, he was Global Head of Complex Structured Products and Regional Head of Non-Core & Legacy at UBS. Prior to that, he was Head of Research at Cairn Capital and co-head of credit research at Barclays Capital, and analyst/portfolio manager at Green T Asset Management and Cabot Square Capital. Stephane started his career as a financial analyst at Goldman Sachs, primarily working on corporate rating advisories. He holds a BSc degree in Economics from the University of Pennsylvania (Wharton School of Business) and is a CFA charterholder.

Source: Hermes as at 30 June 2019.
CFA® is a trademark owned by the CFA Institute.

# Private Debt team

## Biographies

### Laura Vaughan, CFA

Head of Direct Lending

Laura joined Hermes in November 2015, when the private debt platform was being established. Her role has developed from analysing potential fund investments to now also include managing the Direct Lending team. Laura joined from GE Capital, where she was an associate in its mid-market leveraged finance execution team. At GE, Laura focused on arranging financings for European private equity-backed acquisitions funded through senior, second lien, mezzanine and unitranche facilities. Prior to this, Laura worked for three years at Bank of Tokyo-Mitsubishi in its acquisition finance team in London, focusing on opportunities in European large-cap leveraged finance transactions and on portfolio management. Her previous role was at Allied Irish Bank in Dublin in its Corporate Banking North America division, in which she analysed US large-cap and middle-market leveraged finance transactions, and performed portfolio management functions. Laura has an Economics degree from University College Dublin. She is a CFA charterholder.

### Alexandra Trapes

Director

Alexandra joined Hermes in October 2015 from GE Capital in London, where she was a director in the leveraged finance division. In this role, Alexandra was a key member of the team that managed a European leveraged loan portfolio of more than $4.7bn and was mandated lead arranger for mid-cap, club and unitranche transactions. She managed loans extended to companies operating in a broad range of sectors, including business services, retail, food, education and construction. Prior to this, Alexandra worked for six years in the leveraged finance underwriting business of Royal Bank of Scotland, where she focused on UK mid-market leveraged and acquisition finance deals after working on European large-cap private equity-backed transactions. A French national, she holds a Specialised Masters in Corporate Finance from the EM Lyon School of Management and a Master of Science in Management from the ESC Grenoble School of Management.

Source: Hermes as at 30 June 2019.

# Private Debt team

## Biographies

### Maria van der Veer
Director

Maria joined Hermes in March 2018 as a Director in the Private Debt team. She is responsible for executing and monitoring transactions in the UK and Northern Europe for the Hermes Direct Lending Funds. Previously she was a Director in the Kaupthing Singer & Friedlander Leveraged Finance team in London. Within her role she was originating, structuring and executing mid-market sponsor- and non-sponsor-led leveraged transactions in the UK, Benelux and Nordics. Prior to that she worked at Fortis Bank in the Acquisition and Leverage finance team in Rotterdam, focusing on mid-market European syndicated loans. In addition, Maria has worked in strategic fundraising, market intelligence consultancy and account management with multinational companies in the UK and Finland. A Finnish national, she holds a Master of Science degree from Hanken School of Economics in Helsinki, with fluent knowledge of Dutch, Swedish and Finnish.

### Carina Spitzkopf
Director

Carina joined Hermes in January 2019 as a Director in the Private Debt team. She is responsible for analysis and execution of transactions in the UK and Europe for the Hermes Direct Lending Funds. Previously, she was a Director in the UBS Leveraged Finance Risk team, covering leveraged underwriting and lending across EMEA. Prior to UBS, Carina worked at Barclays Capital as part of the team responsible for the firm’s global debt underwriting and bridge financing activity. She started her career with Dresdner Kleinwort in Frankfurt where she was involved in both lending and restructuring of SME and large cap corporates across Europe. A German national, she holds a degree in Business Administration from Passau University, Germany.

Source: Hermes as at 30 June 2019.

# Private Debt team

## Biographies

### Kevin Roche, CFA

Director

Kevin joined Hermes in May 2019 as a Director working in the Private Debt investment team. Previously, he worked as a Director in AIB's Leveraged Finance team where he was responsible for originating and executing loans to mid-market, private-equity backed companies. Prior to AIB, Kevin spent seven years working in a variety of structured finance roles within RBS/NatWest; including Loan Markets, Corporate Acquisitions, Financial Institutions, Asset Finance and Portfolio Management. Kevin started his career as an analyst within Commerzbank AG's Market Risk division. He holds a bachelor's degree in Business with Arts Management from IADT, Dublin and a Master's of Science from UCD Michael Smurfit Graduate Business School. Kevin is an Irish national and CFA charterholder.

Source: Hermes as at 30 June 2019.

# Hermes disclaimer



BD004103

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HERMES
INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

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Infrastructure, private debt, private equity, commercial and residential real estate

**High active share equities**
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**Credit**
Absolute return, global high yield, multi strategy, unconstrained, real estate debt and direct lending

**Stewardship**
Active engagement, advocacy, intelligent voting and sustainable development

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