PRIME CAPITAL

Corporate Debt

Newsletter Q2 2021

Corporate Debt Markets in Q2 2021 – Overview

> Over the last quarter, the share of transaction related financing picked up significant pace, while the share of classic corporate lending also increased (Figure 1).

> Given that the global COVID-19 restrictions are set to be relaxed worldwide, credit rating agencies revised their aggregate default rate forecasts downwards – we thus anticipate higher activity in the corporate lending market going forward.

> Companies across Europe will be looking to refinance restrictive or expiring debt from government relief programs, creating opportunities for banks and debt funds.

> Increased dry powder is likely to lead to more competition for Debt Funds.

> Average Sub-IG spreads slightly decreased from their elevated levels of Q2 2020 through Q4 2020.

European Sub-IG Market

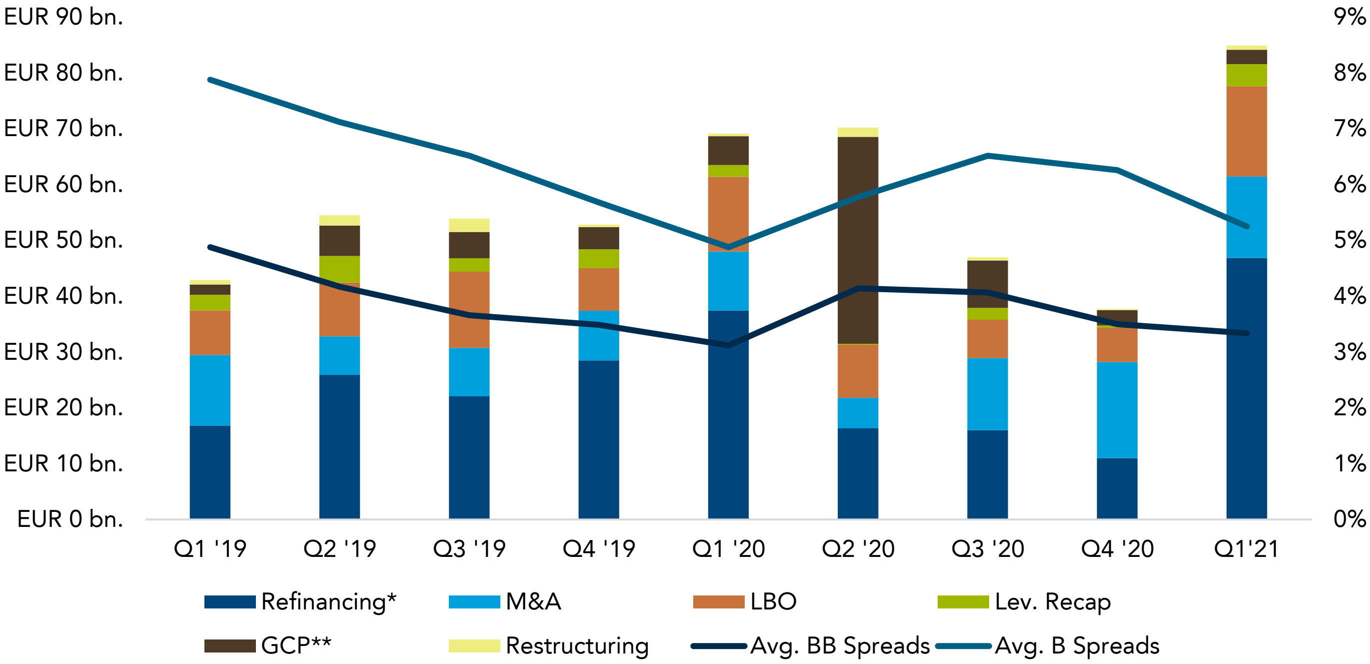

Figure 1: Volume of Sub-IG European debt markets (incl. leveraged loans and bonds) and average spreads.
Source: White & Case (Debt Explorer), PwC Debt Watch Europe Q1 2021

**Refinancing incudes repricing and amendments*
***General Corporate Purposes include Working Capital, SG&A and COGS*

Corporate Debt Market Europe

European Debt Market

According to Preqin, European direct lending funds struggled to deploy capital in 2020, with the amount of available dry powder increasing 43% from USD 44bn at the end of 2019 to USD 63bn at the end of 2020. Preqin notes that for both special situations, dry powder fell from USD 13bn to USD 11bn, and distressed debt, which decreased from USD 16bn to USD 14bn. As the COVID-19 pandemic unfolded, the liquidity added to the system made private debt, already a relatively expensive form of credit for companies, less competitive. It can be expected that the build-up of dry powder translates into increased competition, lower pricing, and weaker terms, putting significant downward pressure on returns.

On the other hand, Banks' approval criteria for loans to firms tightened moderately in Q1 '21, as evidenced by the most recent ECB bank lending survey. This implies less availability of bank financing for corporates and creates opportunities for alternative financiers. Whereas the aforementioned increase in dry powder is a one-time effect, favoured by the pandemic, the structural shift in lending markets due to regulation persists.

Due to well-known trends in monetary policy, the search for yield provided a substantial tailwind to leveraged loans. Especially those at the riskier end of the spectrum outperformed their peers. This is consistent with the development of the returns in the S&P/LSTA Leveraged Loan Index, indicating an above-average performance (Figure 3) with roughly 34bps. QoQ, the index returned 145bps, YoY saw a 1,470bps return, underscoring its strong performance.

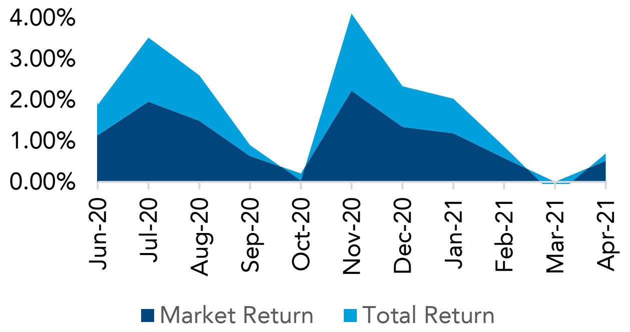

Figure 2 S&P/LSTA Leveraged Loan Index Returns
Source: S&P Global Market Intelligence

LBO financing surged to roughly USD 17bn at the end of March, and is running at the second-highest pace on record - only behind the total USD 61.4 bn. issued in 2007. Total M&A loan volume is at a record-speed too, with USD 73.1bn issued during the first quarter. This is more than 10% ahead of the volume recorded during the first quarter of 2018, which went then on to set the annual record for M&A leveraged loan volume.

In Europe, the high yield bond market activity surpassed its pre-COVID-19 levels. PwC counts 89 deals which have been closed, amounting to a total transaction volume of EUR 52bn - a QoQ pick-up of roughly +21%. Landmark deals included the EUR 1.7bn note program, raised by CVC owned Douglas' in order to recapitalize the struggling perfumery chain or the EUR 1.6bn refinancing of Lufthansa's short term liabilities for the current financial year. Furthermore, leveraged lending activity in European Union surged, especially around transaction based financing. White and Case find that, compared to the previous quarter, LBO and M&A volumes increased by more than 30%, a plus of roughly EUR 7bn. Spreads narrowed (BB: -16bps, B: -101bps) on a quarterly basis and increased slightly (BB: +22bps, B: +37bps) compared to last year. On average, lenders secured pricing arrangements around 400bps whereas the majority of loans did not feature any original issue discount.

DACH Debt Market

SME financing in 2020 was largely dominated by state-backed COVID-19 relief schemes such as CBILS (UK) or Bridge Loan Financing I – III (Germany), which were all characterized by negligible spreads, tight covenants and large amounts of bureaucracy. Since the pandemic seems to fade, companies might seek to refinance those more restrictive loans, as they are coupled to specific use cases (Paying salaries and rent, maintaining min. inventory level, restricting distributions to shareholders etc.). This creates interesting opportunities in the market for SME financings.

The increased need for refinancing (QoQ: +326%, YoY: +25%) in Q1' 21 (Figure 1) shows exactly this: Several COVID relief schemes started to expire and companies sought to amend their loans.

Despite COVID relief schemes some banks and especially debt funds have been conducting several transactions in the German midcap LBO market. This is particularly witnessed in sectors, such as Healthcare, Software and Technology, which in total accounted for more than 65% of all deals in Q1 '21. According to GCA Altiums' midcap monitor, banks funded more than 30% of those transactions whereas debt funds financed 70%. This relation is no coincidence, as the market share for alternative financings has been growing steadily in the German market over the last years.

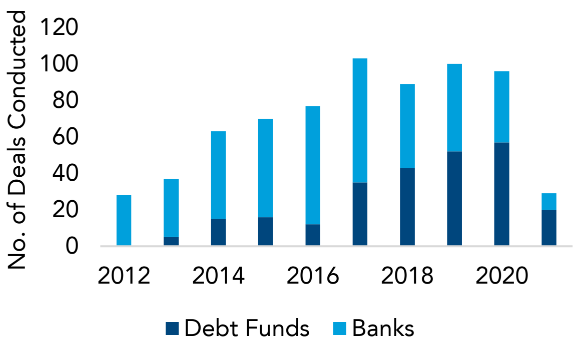

Figure 3: German mid-market financings, including Q1 '21
Source: GCA Altium Midcapmonitor Q4 2020

This development is not limited to Germany. In fact, the wider German speaking area in Austria and Switzerland exhibits similar patterns. However classic relationship-driven lending via commercial banks is still required. Especially for more mature companies, which do not require the, usually more expensive, debt fund offerings.

The current situation remains uncertain, but also creates opportunities: During the start of the COVID-19 pandemic in March last year, market based financing became difficult.

This left the affected companies prone to cash shortfalls and CFOs sought emergency liquidity mainly via revolving credit facilities and short term borrowings.

Financing Conditions

As the COVID-19 pandemic seems to ease, companies throughout Europe now enter the "balance sheet recovery" phase. With a focus on shoring up the balance sheets – that is, refinancing, enhancing cash flows and optimizing the capital structure. This happened under still challenging financing conditions in Q1' 2021, which are still largely dominated by liquidity covenants, EBITDAC adjustments and carve-outs (i.e. for pandemics as default event). Consistent with the improving situation and the high desire to refinance government loans, the trend once more heads towards covenant-lite.

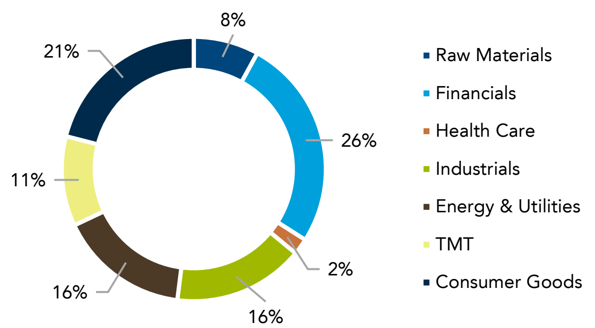

Figure 4: High Yield Volume Europe, Q1 '21 Sectoral Split
Source: PwC Debt Watch Europe, Q1 2021

In terms of sectors, increased strong demand for transaction financing is clearly palpable within Finance (YoY: +14%), as PwCs quarterly Debt Watch finds. Furthermore, the high share (YoY: +20%) of the consumer goods sector can be partially explained by struggling discretionary suppliers' need to refinance beyond governmental COVID-19 schemes. Else, Industrials and Energy & Utilities (YoY: +10%) continue to struggle with the transition towards renewable energies, leading to a higher cost of debt and an increased demand in high yield financing.

ESG integration for Corporate Private Debt

While the general concept of ESG is not new to the corporate private debt space, it still faces substantial challenges in certain parts of the market. Large direct lending managers have been promoting their ESG approach for years, including dedicated ESG Analyst Teams, solely focussing on "E", "S" and "G". Over the past years, the regulatory framework has provided more accurate guidelines on how to approach the topic and while the different fields have become more precise, this also leads to challenges for borrowers as well as for lenders. As in other cases of regulation the one-size-fits-all approach disadvantages smaller borrowers with less resources and who are slower to adapt. Given that private debt is usually a non-control asset class, especially active engagement is often limited and can only be achieved to a certain extend.

Due to lower reporting burdens and less resources a lot of smaller companies still lack a comprehensive and standardized reporting package on ESG relevant data. This information usually needs to be gathered by the lenders through questionnaires, interviews with the company and external research.

Another challenge for lenders is the blind spot aspect, sourcing transactions for an "ESG"-portfolio. As usually little or no information is easily available a detailed view on ESG aspects can only be formed in a later stage of the due diligence process. Given that a meaningful ESG integration requires hard limits and consequences on certain aspects, lenders might face higher broken deal costs, as deals have to be declined at a later stage; or are done anyway putting in question the relevance of the ESG approach. Hence a lot of funds default to exclusion criteria, which can more easily be screened at the beginning of the investment process.

Compared to other asset classes, proceeds in corporate private debt are often used to fund a broad range of applications, from specific expansion projects to general payroll and working capital. This makes it more difficult to tie a loan to a certain purpose and thus to declare it "sustainable". There are numerous example of green bonds and loans to corporate borrowers, with the next evolution being sustainable linked products. However the vast majority remains "general purpose" loans.

According to its slogan "Enabling Alternative Investments", Prime Capital strives to provide institutional investors access to the corporate private debt market, including a meaningful approach to sustainable investing. ESG factors are directly embedded into the risk assessment throughout the life cycle of the investment process. Hence already in deal origination environmental, social and governance factors are considered. These are further analysed during the due diligence phase and monitored throughout the life of the investment. The approach is adapted to deals that exhibit very little information coming from the respective borrowers, so gaps need to be filled by the investment and risk professionals, as part of the in-depth analysis. Given that market access not only includes direct origination but also can include the access through banks for non-sponsored-, non-syndicated deals, the complexity of the analysis can be even higher. This highlights the requirement for an autonomous analysis framework, which does not rely on certain pre-requisites like a company being listed, in order to have sufficient information for an ESG-assessment. Hence the respective products are not limited to a universe, where ESG reporting is already common practice, leaving out companies, which are just starting out to develop their ESG framework and thus should be supported even stronger. This also allows institutional investors, to access the market of relationship driven bank lending, without being restricted to the respective banks ESG initiatives.

About Prime Capital's Private Debt Team

Our corporate debt team has accompanied and executed transaction in excess of EUR 700m. Our Private Debt Team additionally invests into Aviation Debt, Infrastructure Debt and Commercial Real Estate Debt. We expect significant further growth in these areas, which provide attractive risk-adjusted returns to our investors.

Prime Capital's Private Debt Team manages assets in excess of EUR 2bn across the aforementioned asset classes on behalf of institutional investors. Further information about Prime Capital AG can be found on our website www.primecapital-ag.com.

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Prime Capital Corporate Debt Expertise

> Advice and support for corporate debt investments, portfolio strategy and sector allocation

> Managed accounts and funds with investment expertise in various jurisdictions and markets

> Unique "multi-channel sourcing" with access to transactions via direct lending, bank and advisor sourcing on the basis of longstanding relationships to sponsors, advisors and leading banks

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Further information about Prime Capital AG can be found on the web site

www.primecapital-ag.com

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