SUMMARY VIEW OF AND EXPERIENCE IN PRIVATE CREDIT STRATEGIES

by Pavilion Alternatives Group™ staff

Introduction

Pavilion Alternatives Group™ ("Pavilion") advises and manages customised private markets portfolios, including private credit strategies, for sophisticated institutional investors around the world. This paper provides an overview of Pavilion's experience in private credit, its track record, market opportunities and preferred strategies, and reasons why Pavilion recommends including private credit strategies in a private market portfolio or more broadly in an overall portfolio.

Structural market developments, stretched valuations in traditional fixed income securities, heightened competition in private equity and fragile geopolitical and economic conditions help explain why private credit has been gaining an increasing level of attention. Similar to private equity, manager selection is critical in private credit. However, given that the differential between the top quartile and bottom quartile funds is much narrower than for private equity, analysing the level of risk that the fund manager takes to generate its return represents a critical part of the due diligence analysis. With its strong track record of manager selection in private and illiquid strategies and its deep coverage and understanding of the private credit market, Pavilion possesses the appropriate skills and knowledge to construct and manage private credit portfolios and to assist with specific fund manager due diligence. Pavilion has identified private credit investments for a wide range of institutional investors with varying mandates, some income oriented and others seeking higher absolute returns. Since 2006, Pavilion has researched and evaluated the private credit market globally and recommended 25 funds totaling USD2.5 billion on behalf of its clients.

1. Why Private Credit Strategies?

There are several reasons why private credit strategies make sense within a credit portfolio as well as within an overall portfolio.

Attractive risk / return profile

In the U.S. and Europe, demand for alternative sources of credit capital has increased, particularly in the small and lower-corporate mid-markets, and for infrastructure projects and real estate investment activity as well. Overall, private credit managers raising closed-end funds covering these different sectors have been able to generate a premium over traditional fixed income assets, sovereign debt and corporate bonds as they fill the void[1] generated by the new financial regulations which have pushed banks to retrenched from certain types of lending activity. Moreover, private credit funds are frequently able to generate a higher level of liquidity through interest payments and shorter holding periods than a typical private equity fund. Most managers also have the flexibility to provide floating rate structures, which is an important risk mitigator if rates rise. Finally, many of the regulatory changes that have occurred are structural, which means that the investment opportunity should remain even in a higher rate environment.

Diversification

Correlation between the high-yield markets and public markets is high. It is lower for private credit strategies and clearly lower for select sub-strategies, such as distressed strategies. Also, the correlation between the traditional fixed asset class and private credit is very low. Based on MorningStar data for the period from 1992 to 2014, the correlation between private debt and public bonds was 0.06.

Access to a segment of the economy not covered by more liquid credit strategies

Many small and medium-sized companies in the U.S. and Europe, typically those below USD600 million or EUR500 million in enterprise value, have limited or no access to the high-yield market for debt finance. Investing in private credit strategies allows investors to get access to this attractive segment of the market which offers a premium over more liquid securities.

Increasing market depth

The number of fund managers with meaningful experience and a strong track record has increased, especially in Europe where there was a lack of such managers prior to the Great

1: Past Performance is no guarantee of future results

Financial Crisis (GFC). Pavilion is also seeing a deepening of the market in areas such as Real Estate Credit and Infrastructure Debt.

2. Pavilion's Private Credit Experience

Elvire Perrin, Managing Director, leads Pavilion's Private Credit team. She is assisted by four experienced professionals globally. **Raelan Lambert** and **Jeff Kopocis** support coverage of the U.S. market (Sacramento and Richmond offices), **Scott Wilkinson** of the European market (London office), and **Charles Chiang** of the Asian market (Singapore office). Biographies of the professionals are provided in the Appendix.

Although Pavilion's geographic coverage is global, it focuses on the markets where the investment opportunities are most abundant - the U.S. and Europe. However Pavilion has, recently recommended private credit funds in Asia because there are a handful of fund managers of high quality in this region.

Pavilion's proprietary database contains 825 credit funds, broken down as follows:

- 298 distressed / special situations
- 228 mezzanine / junior debt
- 176 senior debt / direct lending funds
- 40 real asset related credit funds
- 12 venture related credit funds
- 71 other type of credit funds

The following examples demonstrate the breadth of Pavilion's experiences in private credit[2] :

<u>Example 1:</u> Building a private credit portfolio from scratch (GBP100 million)

An existing private equity client decided to dedicate a specific pool of capital to invest in private credit strategies. The goal was to enhance the credit return given the lacklustre performance of the fixed income portfolio. Pavilion was ultimately chosen through the client's selection process with a mandate to deploy GBP100 million in three to five high-quality credit funds active in Europe and the United States. Portfolio construction, manager selection, and key legal terms negotiations were all led by Pavilion.

<u>Example 2:</u> Re-focusing and monitoring of an existing private credit portfolio (USD1.25 billion)

Pavilion was selected by an existing private equity client to review and monitor its USD1.25 billion private credit portfolio with the aim of refocusing the program. The mandate included selecting new private credit funds to complement the existing portfolio to achieve the client's 2.5% target allocation in the total portfolio. From 2011 to 2015, Pavilion recommended a total of 19 funds with an average yearly commitment of USD300 million. Part of the service to this client included a yearly credit pacing plan with cash-flow modelling.

<u>Example 3:</u> Conducting independent due diligence (USD1.5 billion)

Pavilion was chosen through a bid invitation process to evaluate several separately managed account providers. The client wished to achieve a minimum 12% gross IRR and only be exposed to the European credit market. The mandate included conducting thorough, independent due diligence on three providers and presenting the findings in a detailed investment report for each potential manager relationship.

<u>Example 4:</u> Building private credit exposure as part of a global portfolio

Pavilion was asked by a European insurance company to conduct a strategic review of its alternative investment portfolio, evaluating the impact on the overall portfolio of increasing the size the alternative program. The client provided guidelines on its standard deviation and solvency capital ratio requirements (using Solvency II guidelines). Pavilion used its proprietary model to measure the impact of including different alternative asset classes on these requirements, as well as the impact on returns. Pavilion concluded that the best-suited option for increasing the company's alternative exposure was a diversified private credit portfolio mainly focused on Europe and the U.S., consisting of corporate credit as well as infrastructure debt. Consequently, Pavilion worked with its client to structure the portfolio, selecting the best fund managers for each underlying credit sub-strategy.

Pavilion encourages clients investing from their private equity allocation to focus on opportunities providing an expected net IRR greater than 10%. These are typically oriented to mezzanine and distressed/special situations opportunities. For distressed/special situations funds, returns range between 10% and 15%+ net, and for mezzanine funds between 10% and 14% net.

For clients looking for an alternative or complement to traditional fixed income investments, Pavilion has recommended lower risk/lower return strategies offering attractive yields. In light of the lower risk profile of direct lending strategies overall, the expected net (unleveraged) return of the funds Pavilion has reviewed ranges between 7% and 12%. Return expectations vary depending on the specific strategy, leverage used and potential equity participation.

For clients in highly regulated industries, such as insurance and banking, Pavilion will employ proprietary models to gauge the impact of including private credit securities in

2: Past Performance is no guarantee of future results the portfolio. Pavilion is familiar with Solvency II regulations in respect of solvency capital requirements and reporting requirements. It works with fund managers to ensure their understanding and compliance. The firm is also experienced with BIS reporting requirements for banks, and works with fund managers to ensure that they are able to comply.

3. Pavilion's Track Record in Private Credit

Pavilion has recommended, conducted due diligence on, or monitored 53 private credit funds. Since 2006, Pavilion has recommended 25 private credit funds, totalling USD2.5 billion of commitments. In addition to these 25 funds, Pavilion performed due diligence on eight funds which are not currently being monitored as the monitoring service was not included in the respective mandates. Pavilion monitors an additional 20 funds totalling USD1.6 billion, which were existing legacy commitments in clients' private credit portfolios.

The track record displayed below includes all the funds Pavilion has recommended excluding funds in 2015, which are still immature.

Table 1: Pavilion Recommended Funds' Track Record

Vintage	Net Multiple of Cost	Net IRR
2006	1.5x	10.1%
2007	-	-
2008	-	-
2009	1.5x	18.4%
2010	1.4x	11.6%
2011	1.6x	17.5%
2012	1.2x	13.7%
2013	1.0x	1.8%
2014	1.1x	7.3%
2015	n/a	n/a
Total	**1.2x**	**11.6%**
Direct Lending	1.1x	7.5%
Distressed	1.3x	12.0%
Mezzanine	1.2x	12.2%

Notes: Cash flows are converted into USD using 31 March 2016 exchange rates; calculated with a fixed exchange rate to exclude currencies impact and that net of fees and carry. 2015 funds are not included in the track record as they are not meaningful. Potential investors are reminded that past performance of any investment is not indicative of future returns.

Of the 25 recommended funds, 61% were principally focused on U.S. opportunities, 34% were focused on European opportunities, and 5% were focused on Asian opportunities. Many funds have geographical overlap. Charts 1 and 2 summarise the sub-strategy and geographic scope of the funds.

Chart 1 – Pavilion's Recommended Private Credit Funds

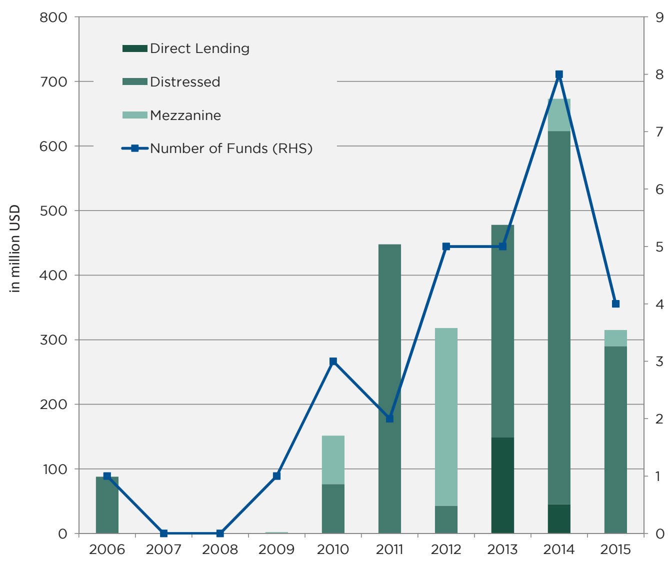
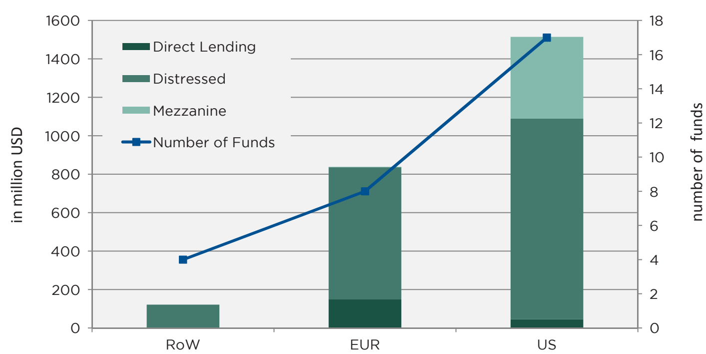


Chart 2 – Pavilion's Recommended Private Credit Funds By Geography and Strategy



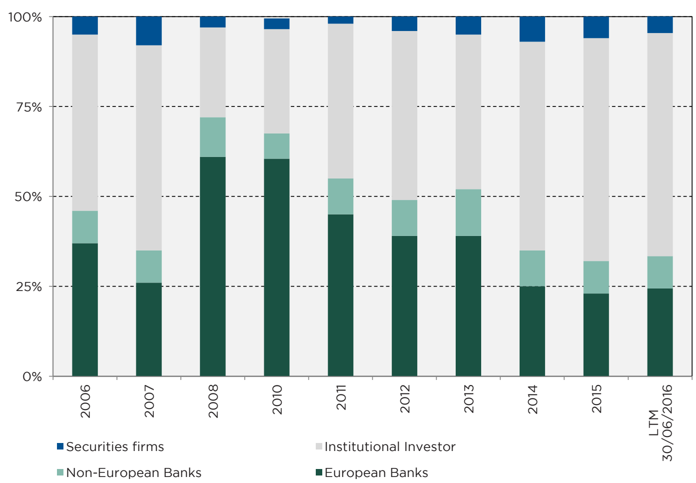
Pavilion's commitments to private credit funds have increased over the last few years. The average amount deployed from 2013 to 2015 was EUR560 million p.a. compared to EUR410 million p.a. from 2006 to 2015. There are three primary reasons for this increased commitment pace:

- Clients' desire to mitigate the "J curve" of their private market portfolio;
- Clients' search for an alternative to low yielding traditional fixed income strategies; and
- Greater high quality funds' availability due to deeper private credit markets.

4. Market Opportunity and Preferred Strategies

The 2008/09 Global Financial Crisis and ensuing low rate environment drove prices of traditional fixed income assets to historic highs and yields to historic lows. Meanwhile, structural regulatory changes forced traditional capital providers to retreat from the market. In combination, this has created greater opportunity for private capital providers to fill a massive credit funding gap and charge a premium for doing so. The increase in investors' interest is reflected in the fundraising figures for private credit funds, as shown in Chart 3.

Chart 3: Annual Private Debt Fundraising, 2009-Q2 2016



Source: Preqin Private Debt Online

Direct Lending

In the wake of bank deleveraging, large, globally active fund managers from both private equity and fixed income have increased their activity in the direct lending market to benefit from the increasing level of opportunities and attractive risk return profile. Direct lending is attractive throughout the U.S. and Europe. Across both geographies, the smaller end of the market and non-sponsored transactions are appealing because competition is more limited than the larger end of the market and the sponsor-backed deals as barriers to entry are higher, generally allowing investment managers to charge more for their capital and exercise greater control over the terms of the loan. Senior secured lenders can generate solid returns (6 to 9% net) while seated at the top of the capital structure. Other strategies that blend senior security with junior debt and potential equity upside investments are able to generate higher returns (8 to 13%) but with a higher level of risk. These investments also typically offer cash yield, which helps mitigate the J-curve effect, and the ability to use floating interest rates, which lessens the risk in a rising rate environment.

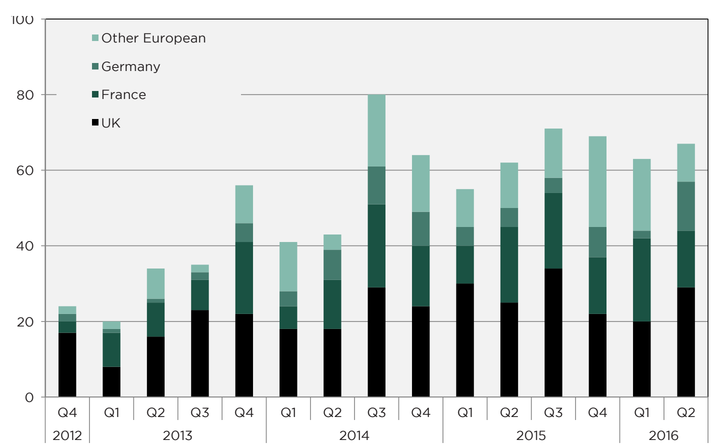
U.S. Market: Although there has been a meaningful and rapid increase in the number of new private lenders in the U.S. since 2009 (estimated to be over 150 including Business Development Corporations or "BDCs"), the number of U.S. banks has decreased by approximately 1,200 during that same period based on data from the Federal Financial Institutions Examination Council (U.S.).

Banks in the U.S. (and around the world) continue to face significant regulatory pressure; risk-based capital charges for non-rated loans and Tier 1 capital ratio increases are making it increasingly challenging for banks to provide loans to small and mid-market companies. Whereas commercial bank deposits have increased substantially since 2011, the pace of loans and leases growth has been much slower. Therefore, direct lending investment managers and BDCs have emerged as a structural replacement for banks in the viewpoint of borrowers.

Not only are there significantly more companies in the small and mid-market compared to the large market, there are also fewer well-capitalised lenders, which creates an opportunity for lenders with a sufficient capital base to underwrite the entire debt solution. Given that small and medium-sized businesses comprise 99.7% of U.S. employer firms and approximately 50% of U.S. GDP, the opportunity to provide capital is significant[3].

European Market: Europe is in transition toward the U.S. model, where banks participate in less than 10% of the total leverage loan market in the corporate space. According to Deloitte, deals completed by alternative lenders in Q2 2016 have increased by 3% to 67 deals from 65 in Q1 2015, showing a certain level of deceleration in market growth, when compared to the growth rate of 43% from Q1 2014 to Q1 2015. However, as can be seen in the chart below, the trend remains positive and the recent deceleration in the first part of 2016 is attributed mainly to the level of uncertainty created by the prospect of the UK Referendum on the decision to remain or not in the European Union.

Chart 4: Alternative Lender Deal Tracker

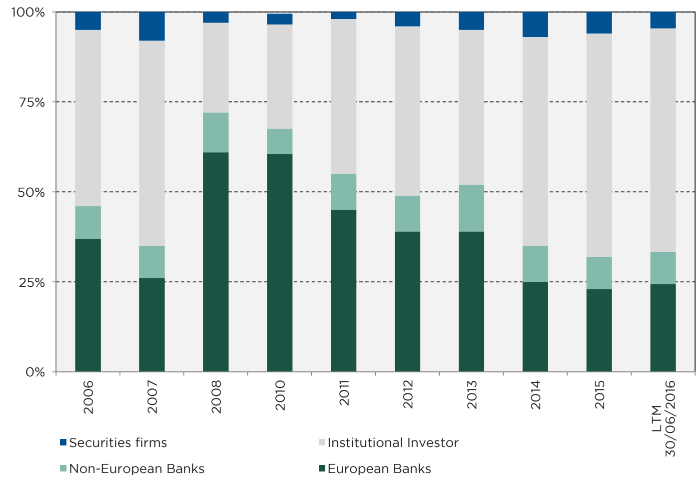


Note: Currently covers 47 leading Alternative Lenders. Only primary mid-market UK and European deals are included in the survey.

3: "Small Business GDP: Update 2002-2010", U.S. Small Business Administration

There is no doubt that the share of lending done by banks has decreased substantially since the GFC. According to S&P and as displayed in the chart below, banks represented 33% of the leverage loan market at the end of Q2 2016 compared to 73% in 2008.

Chart 5: European Leveraged Loans by Type of Lenders Direct Lending in Europe: An Opportunity Driven by Structural Changes



Source: LCD Leveraged Loan Review, 2Q 2016. 2009 not included due to insufficient data.

Despite the increasing level of investment opportunities, one may ask whether the amount of capital being raised in direct lending will enable fund managers to maintain the substantial premium (estimated to have been between 200 and 400 basis points, on average, during the past few years) over liquid credit markets. Deloitte estimates that European direct lending funds are currently looking to raise approximately EUR17.2 billion in commitment (compared to USD30 billion for U.S. Direct Lending funds).

Banks primarily invest in deals over a certain transaction size, where the debt is rated and the deal structure is standard. They tend not to be involved in smaller and less liquid transactions, and especially when there is a certain level of complexity involved. More recently, banks have teamed-up with direct lenders in deals where banks secure the less risky layer of the financing package. But even for larger deals, the environment is changing. Indeed direct lending continues to evolve and now competes with traditional debt capital market solutions as deal sizes continue to increase[4]. This is explained by the fact that credit fund managers offer more flexibility when they structure loans and are more inclined to take into account the specificities and needs of each company to which they lend. Their speed of execution is also often mentioned as one of the reasons why companies or private equity sponsors choose a credit fund rather than a bank as its lender.

In both the U.S. and European markets, the increase in recent fundraising has been putting a certain level of pressure on pricing and the historical premium over public credit strategies. However, the premium remains meaningful and continues to attract global investors.

Direct lending to growth companies or specialty lending in the U.S. and Europe has also emerged as an attractive niche. Commensurate with the higher risk, expected returns in direct lending to fast growing companies or complex situations are higher than in a typical direct lending fund (typical gross targeted IRRs are in excess of 15%) and generally comprise an element of equity upside.

Distressed/Special Situations

At the exception of a couple of sectors (Energy and Metal & Mining), the lack of broad market distress means that certain investment managers that target corporate distress, for instance, have found it more difficult to deploy capital, and those opportunities that do exist are competitive, which can limit their return appeal.

More recently, given the dramatic drop in oil prices, opportunities have emerged for private credit strategies that capitalise on the energy market dislocation. Although private energy managers are best positioned to generate outsized returns over extended time periods, there have been opportunities for private credit investors to capitalise on energy junk bonds, special situations and direct lending.

However, oil prices would have to remain below USD75 per barrel and companies would need to start breaching their covenants and defaulting on their debt payments before the true distressed energy opportunity arises. If that happens, there should be a real level of distress in energy junk bonds, which make up approximately 16% of the Barclays High-Yield Index[5]. Since 2015 and as at September 2016, 65% of the defaults in the high yield markets have taken place in the energy sector based on JP Morgan's data.

A certain level of uncertainty in global markets has been triggered by Brexit and the U.S. election, which has pushed the IMF to lower its growth level expectation for developed markets, including the United States. Also, Pavilion has been hearing from distressed fund managers that there is starting to be an earning recession across the board, not just Energy and Metal & Mining. It would seem that the seeds for the next distressed cycle have been sown. In the U.S., private equity purchase price multiples are near record highs, as are debt levels. It should be noted though that equity contribution levels are near 15 year highs and that the underlying companies are generally in better health than they were several years ago.

As can be seen in the chart below, high-yield issuance has been near the all-time high in the U.S. on an annual basis over the last five years despite the recent deceleration.

4: Deloitte Alternative Lender Deal Tracker, June 2016
5: JP Morgan Credit Strategy Weekly, September 2016

Default cycles typically have a strong correlation to high-yield issuance, and distressed cycles have typically been between six and eight years apart. However, the monetary policies which have been applied on the U.S., Europe and Japan have had major impacts on cycles. These do not seem to take place in the same way as they used to historically.

North American and European distressed debt fundraising has been stable over the last three years. Investor appetite has been limited for distressed investments in the U.S. compared to other periods, as central bank intervention has supported the prices of financial assets and increased the lure of other private equity strategies such as buyouts. Based on Preqin data, North American and European distressed managers raised USD79.1 billion in 2015, which is 10% above the 2014 amount of USD71.8 billion. The increase is mainly explained by large distressed funds being raised to target the energy sector, such as GSO Energy Select Opportunities Fund, closing on USD2.5 billion.

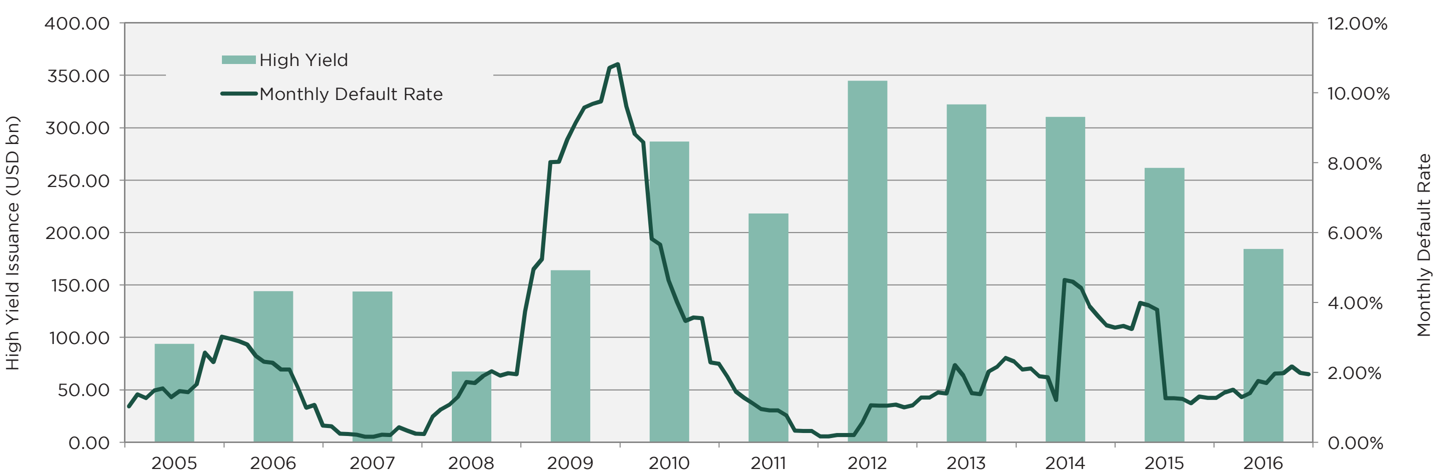
There has been a specific interest for European distressed opportunities in the last few years though as investors have been seeking to capitalise on Europe's economic weakness and regulatory changes which are accelerating asset sales from depository institutions. However, figures seem to be saying that the capital raised has not been deployed as quickly as expected. In fact, based on the Preqin data, the European dry powder for distressed investing has increased from EUR15.5 billion in 2010 to EUR54.5 billion in 2016, increasing steadily each year6. Pavilion's view is that most of the fund managers raising capital over the last five years in Europe, were expecting opportunities to increase at a much higher pace that what actually happened. The main source of opportunities coming from the banks' deleveraging process in Europe has been slower than expected. The wave of distressed opportunities expected by some has not taken place. Instead, there has been a steady level of distressed opportunities which is expected to last several years. Pavilion expects the fundraising activity to adjust to this new reality.

It is hard to predict when the next market distressed cycle will occur in the U.S. though. It is important, however, for prudent investors to consider their allocation to distressed managers now, to avoid trying to time the next distressed cycle or miss out on continued distressed opportunities, which differentiated managers continue to find. Pavilion has been focusing over the recent years on distressed and special situations fund managers which do not need a strong distressed cycle in order to deploy capital. These managers tend to have funds of a size below USD2 billion.

Conclusion

The current environment offers attractive opportunities for private credit investors to exploit in the U.S. and Europe. Pavilion has seen an increase in appetite from the investor community for private credit strategies in recent years for a variety of reasons. The low-yield environment is pushing investors to search for new sources of yield. In addition, structural changes in the regulatory environment are forcing banks and other traditional financial players to limit their exposures to SME lending and Real Estate and Infrastructure debt but to a lesser extent, which has created interesting opportunities for private credit fund managers to fill the capital void and generate solid risk-adjusted returns. More recently, there have been pockets of stress and distress, with the next distressed cycle anticipated during the coming years.

Chart 6: U.S. High Yield Issuance and Default Rate, 2005-2016 (through September 30th)



Source: S&P, U.S. LDC Quarterly, Q3 2016

6: Preqin Special Report, North America and Europe Distressed Debt, February 2016

APPENDIX – Private Credit Investment Professionals

Elvire Perrin, Managing Director

Elvire Perrin is a Managing Director on the global Advisory Team based in the London office. Ms. Perrin is primarily responsible for global Private Credit Strategies.

Since joining in 1999, Ms. Perrin has been responsible for coverage of the private equity market in Continental Europe. She was instrumental in the research effort that led to identifying the potential risks associated with the technology venture market in 2000, subsequently resulting in the firm advising clients not to invest in the venture investment bubble and thereby avoiding the crash. She also developed an approach to peer group analysis of general partners. This approach is a key aspect of Pavilion's Research and Investment Process today.

Raelan Lambert, Managing Director

Raelan Lambert is a Managing Director on the global Advisory Team based in the Sacramento, CA office. Ms. Lambert joined the Firm in 2005, and has 11 years of private equity experience and 18 years of industry experience. Ms. Lambert provides private markets advisory services to a variety of clients in the U.S., Canada and Middle East and has focused on Asia and Emerging Markets managers and special situations strategies globally.

Ms. Lambert has covered private credit strategies for nearly 12 years, including the initial development of our research of specific opportunities across special situations, opportunistic credit, direct lending, mezzanine and tactical opportunity strategies.

Jeffrey A. Kopocis, Associate Director

Jeffrey Kopocis is a Associate Director on the global Advisory Team and is based in the Richmond, VA office. Having joined the firm in 2013, Mr. Kopocis leads and participates in the identification, evaluation, selection, and monitoring of funds across a variety of private market strategies. These strategies include early stage venture capital, small and middle market buyouts, large market buyouts, secondaries, co-investments and real assets in North and Latin America.

Mr. Kopocis co-leads North American private credit research and investment. He has contributed to several private markets research pieces concerning private credit portfolios and investments, and frequently lends his thoughts about economic and investment conditions influencing this space. He has provided input on North American private credit for work Pavilion has conducted for European insurance companies, including the construction of portfolios under Solvency II.

Scott Wilkinson, Associate Director

Scott Wilkinson is a Associate Director on the global Advisory Team and is based in the London office. Mr. Wilkinson is responsible for covering a number of Pan-European and regional managers, in addition to the U.K., Southern Europe and African markets. Since joining the firm in 2009, he has accumulated experience across buyout, credit, venture and real asset strategies, as well as other private equity functions, such as reporting and monitoring, and operational management of fund of fund vehicles.

Mr. Wilkinson co-leads Pavilion's European private credit investment and research. For a client, a European insurance company, he has developed a dynamic model for gauging the impact of alternative investments on returns, solvency capital requirement and risk. This led to the client's implementation of a private credit portfolio. Mr. Wilkinson has been actively involved in Pavilion's work with insurance companies wishing to expand their alternatives portfolios in the Solvency II environment. He has also worked alongside Ms. Perrin with private market fund managers to test their ability to supply information required under Solvency II reporting guidelines, including the TPT.

Charles Chiang, Associate Director

Charles Chiang is a Associate Director on the global Advisory Team and is based in the Singapore office. Mr. Chiang joined the firm in 2014. He focuses on sourcing, evaluating and monitoring private equity funds in Asia. Mr. Chiang has been working in the financial services sector since 2005, focusing on private equity since 2008.

Prior to Pavilion, Mr. Chiang worked for Capital Dynamics as an Associate, where he evaluated private market fund investment opportunities in Asia Pacific, as well as monitored existing fund portfolios for the fund of fund and clients.