WELCOME

THE DEBT FORUM
CLOs & DIRECT LENDING FUNDS
OPENING ADDRESS:

Fabrice Susini
Global Head of Securitisation
BNP Paribas Corporate Investment Banking
The Debt Forum

CLOs & Direct Lending Funds
CLO market is recovering...
Zooming on 2013


- **50% increase** in the US
- **Steady** issuance in the US

European CLO 2.0 Cumulative Issuance vs. US CLO Cumulative Issuance, 2013

US vs. European CLO issuance: **x10**

Why?
Among various explanations, one key factor…

Articles 404-410 of the Capital Requirements Regulation ("CRR") (EU Risk Retention Rules) to mention a few:

- So far, risk retention rules were spelled out in Article 122a of the Capital Requirements Directive ("CRD")
- On 27 June 2013, CRR was formally adopted, which replaces the CRD starting from 1 January 2014
- In May 2013, the European Banking Authority published its consultation paper on the Regulatory Technical Standards ("RTS") in respect of the new CRR retention rules:
  - There remains great uncertainty with regard to the content and impact of the final version of the RTS
  - The CRR will effectively remove the flexibility around the definition of sponsor, meaning that the CLO manager as a credit institution or an investment firm has to raise and retain the 5% risk retention requirement, rather than relying on a third party to act as retainer
  - In addition, the CLO managers will be subject to the Markets in Financial Instruments Directive ("MiFID") (which would thus exclude non-EU managers and managers subject to the Alternative Investment Fund Managers Directive)
  - Final version of the RTS is not expected before the end of the year, with a further review by the Commission thereafter. CRR will therefore be in application before the final rules are known

...an uninterrupted deluge of regulations for banks, insurance, funds
European vs. US CLO Issuance

Arbitrage CLO Issuance

EUR bn

Europe
US

…mostly in the US but even in Europe we are seeing green shoots of recovery
The European CLO market has re-opened, stronger than forecasted at the beginning of the year:
- 14 deals have closed as of beginning of November, representing a total issuance volume of around EUR 4.9bn, with 3 additional transactions priced (EUR 1.2bn) and further CLOs are being prepared;
- The AAA pricing range has been 125-155 bps so far, with most of the deals settling around a ‘sweet spot’ of 135bps, although there is recent upward pressure on AAA spreads;
- Loan supply remains a concern in Europe, but loan issuance has picked up in 2013. Managers’ ability to successfully ramp-up an appropriate portfolio seen as crucial by investors.

Factoring structural developments in CLOs 2.0:
- Lower leverage (~ 5-7x) and higher AAA subordination (~ 40%) than pre-crisis CLOs
- Shorter non-call and reinvestment periods: typically 2yr non-call, 3-4yr reinvestment
- Limits on lowly-rated countries, addressing concerns on peripherals
- More flexibility in including senior secured bonds, reflecting the current state of the HY market (e.g. Pramerica, Carlyle CLOs)
- CCC buckets of 7.5%
- Already the return of multi-currency features? Three deals already are including GBP tranches
- Lower manager cost structure: e.g. 15 bps senior, 35 bps subordinated, 10% excess incentive fee on top of target IRR of 12%

Regulatory hurdles overcome:
- Two retention approaches used so far in CLOs 2.0: retention of first loss piece or of a vertical slice, with the market moving more and more towards the vertical retention as the standard approach
- Out of the 14 CLOs that have closed this year, more than half would be compliant with the proposed new retention rule, with the remaining minority choosing not to comply or working under assumptions of the previous guidelines…
Challenges remain…

1/ Debt Fund vs CLO: complementarity or competition…

**Debt Fund**
- A simple and transparent design?
- A complementary tool to the lending landscape?

**CLO**
- An over-engineered answer?
- A tool for lending on an industrial scale?

2/ Regulation and communication…
- Growth contribution and value creation?

3/ Standardisation and transparency across Europe
- And how could we contribute?
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How do debt funds and CLOs co-exist in today’s market?

Chairperson: James Williams, Managing Editor, Global Fund Media Ltd
Dagmar Kent Kershaw, Head of Credit Fund Management, Intermediate Capital Group
Neil Basu, CEO & Founder, Pearl Diver Capital
Martin Sharkey, Senior Associate, Banking & Finance, Capital Markets at Clifford Chance
Rob Reynolds, Managing Director, Debt Management, 3i Group
A case study: How to construct a debt fund

Chairperson: Stuart Draper, BNP Paribas Securities Services
Ross Youngs, Head of Sales, BNP Paribas Securities Services Channel Islands & Isle of Man
Tim West, Partner, Herbert Smith Freehills
Ravi Anand, Head of Corporate Finance, Dexion Capital plc
Jonathan Bowers, CVC Credit Partners
What risks do regulations pose to Europe’s CLO market?

Chairperson: Antoine Chausson, Senior Structurer, BNP Paribas Asset Securitisation Group, Banking Solutions & Regulatory
Colin Atkins, Head of European Structured Credit Advisory Team, Carlyle Group
Steve Baker, CFA, Apollo Global Management LLC
James Waddington, Partner, Dechert
Georges Duponcheele, Fixed Income, BNP Paribas
How should one rate debt funds from a risk management perspective?

Alastair Sewell
Director, Fund and Asset Manager Ratings Group
Fitch Ratings
Rating Debt Funds
Presentation to:
The Debt Forum

Alastair Sewell, Director
Fund & Asset Manager Ratings

November 2013
Agenda

Why?
What?
How?
Related Research
Agenda

Why?

What?

How?

Related Research
Reallocation in Bank Funding…
...Fuels Shift to Capital Markets for Corps, CRE and Infra

Risk Exposure (EAD): Modest Reduction, Major Reallocation

(Change in EAD since End-2010 (EURbn)

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EMEA Corporate New Issuance

Bond issuance (LHS)
Loans
Bonds as % of total new debt (RHS)

Source: Fitch Ratings; bank Pillar 3 disclosures (sample of 16 European G-SIBs).
Source: Dealogic, Fitch
Long-term Investors

- EUR8tn of pension and insurance investment capacity seeking returns;
- Ready to capture an illiquidity premium;
- Keen on:
  - Floating rate exposure;
  - Secured creditor status;
  - Long term assets; and,
  - Limited mark-to-market volatility.
Agenda

Why?
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Related Research
Fund Legal Structures

- Closed ended;
- Structured as corporate entity, regulated closed end fund, QIF or SIF;
- Levered or unlevered;
- Generally club deals with one or several ramp-ups.
Fund Operational Structure

Rating Debt & PS Issued by Non-US CEFs

Source: Fitch
Rating Definitions

Issuer Default Ratings

… opine on an entity’s relative vulnerability to default on financial obligations.

Fund Credit Ratings

… an opinion as to the overall credit profile and vulnerability to losses as a result of defaults within a fixed-income portfolio.
Agenda

Why?
What?
How?
Related Research
Rating and Review Process

**Document Review**
- Fund structural features
- Legal & regulatory considerations

**Manager Assessment**
- Review of asset selection process
- Analysis of portfolio construction principles
- Detailed review of organisation and procedures

**Portfolio Analysis**
- Analysis of portfolio holdings and structure
- Rating committee validation and decision

**Rating Issuance**
- Communication to manager
- Press release to media & investors
- Publication of rating report

**Surveillance**
- Periodic portfolio and fund manager monitoring
- Full annual rating review

**Manager Contact**
- Dialogue maintained with manager throughout rating process

**Investor Contact**
- Fitch website
- Analysts interact with investors
- Rating announcement via press release

Approx. eight weeks
Assessing the Fund Manager

Manager Capabilities
- Staffing
- Resources
- Processes
- Operational Controls

Manager Roles
- Asset Selection
- Monitoring
- Asset Substitution
- Workout

Manager Assessment

Asset Manager Rating Criteria (April 2013)

Source: Fitch
Portfolio Rating Considerations: Average Credit Quality

- A portfolio’s Weighted Average Rating Factor (WARF) serves as the primary driver of the Fund Credit Rating
- WARF based on Credit Opinions or Ratings on portfolio assets
- WARF = Sum [Rating Factor X Market Value OR Fair Value]

<table>
<thead>
<tr>
<th>WARF-implied Rating</th>
<th>Expected WARF Range</th>
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<tr>
<td>AAA</td>
<td>0 to 0.4</td>
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<tr>
<td>AA</td>
<td>0.4 to 1.1</td>
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<td>A</td>
<td>1.1 to 3.1</td>
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<td>BBB</td>
<td>3.1 to 11.0</td>
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<td>BB</td>
<td>11.0 to 25.0</td>
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<td>B</td>
<td>25.0 to 47.0</td>
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<td>CCC &amp; Below</td>
<td>Over 47</td>
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</table>

Guideline WARF Ranges

Source: Fitch

Fitch Rating Factors

Source: Fitch
Portfolio Rating Considerations: Stress Testing

Tail Risk & Concentration
- Largest issuers
- Largest WARF contributor
- Assets on RON / RWN
- Sector
- Geography

Recoveries
- Adjustments for recovery rates that deviate from standards
- Fund “tail periods” providing additional time to realise recoveries

To capture portfolio tail risks
Rating Considerations: Fund Life Cycle

Fund Life Cycle

Need for detailed investment guidelines if the rating is assigned before the end of the ramp-up period

Source: Fitch
Debt Rating Considerations: Cash Flow Analysis

- Analysis similar to cash flow CLO;
- Use of PCM model coupled with cash flow analysis;
- Additional consideration is the risk of early redemption.

Rating Debt & Preferred Securities Issued by Non-US Closed-end Funds (March 2013)
## Debt Rating Considerations: Applicable Criteria

<table>
<thead>
<tr>
<th>Assets</th>
<th>Analytical Approach &amp; Fitch Group</th>
<th>Applicable Rating Criteria</th>
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<tbody>
<tr>
<td>Corporate loans (mid to large companies)</td>
<td>Portfolio Credit Model (PCM) using default probability and recovery assumptions on individual assets</td>
<td>Global Rating Criteria for Corporate CDOs, 8 August 2013</td>
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<td>Fitch Group = Structured Credit</td>
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<td>Corporate loans (small to mid-sized companies)</td>
<td>PCM using average default rates as a starting point assuming granular portfolios</td>
<td>Criteria for Rating Granular Corporate Balance-Sheet Securitisations (SME-CLOs), 28 March 2013</td>
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<td>Fitch Group = Structured Credit</td>
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<tr>
<td>Commercial real estate loans</td>
<td>CMBS type assessment</td>
<td>EMEA CMBS Rating Criteria, 3 April 2013</td>
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<td>Fitch Group = CMBS</td>
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<td>Infrastructure Loans</td>
<td>Individual asset specific</td>
<td>Rating Criteria for Infrastructure and Project Finance, 11 July 2012</td>
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<td>Fitch Group = Global Infrastructure</td>
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Source: Fitch
Agenda

Why?
What?
How?

Related Research
Related Research

- Basel III Shifting the Credit Landscape (November 2013)
- Corporate Funding Disintermediation Dashboard Q313 (October 2013)
- European Asset Management (October 2013)
- U.S. CLO Asset Manager Handbook (October 2013)
- European Leveraged Loan Chart Book (September 2013)
- EMEA Corporate Bonds: Rating and Issuance Trends (August 2013)
- Global Bond Fund Rating Criteria (August 2013)
- Rating Debt and Preferred Securities Issued by Non-US Closed-End Funds (March 2013)
People in pursuit of answers
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KKR perspectives on European direct lending

Marc Ciancimino
Managing Director & Global Head of Mezzanine
KKR Asset Management
KKR Perspectives on Direct Lending
Marc Ciancimino – KKR Asset Management

Debt Forum November 2013
What is direct lending?

Generally perceived as mid-market senior or unitranche financing which is either priced or levered higher than conventional bank debt. In reality it covers a much broader range of situations.

KKR definition:
Non-syndicated, illiquid credit facilities negotiated directly between issuer and lenders where pricing, structure, terms and covenants are highly tailored to satisfy issuer and lenders rather than solve for a broad syndication / capital markets process. Can be anywhere in the capital structure.
Why do issuers consider direct lending?

Many reasons:

• Need for greater flexibility than normal deal
• Smaller size which doesn’t suit capital markets distribution
• Specific structural problems to solve
• Lack of conventional bank lending availability e.g. because of jurisdiction
• More leverage than normal situations
• Storied credit e.g. previous restructuring or out of favour sector
Case Study: Hilding Anders

Company summary

• Leading manufacturer of beds and mattresses
• Headquartered in Sweden but global footprint
• Revenues and EBITDA of €857m and €124m
• Owned by Arle who acquired from Investcorp in 2006

Reasons for needing direct lending

• Not an attractive time to exit given scope for earnings growth
• Short term covenant pressure
• Leverage too high for conventional capital markets execution
• Needed to put the company back on a long term footing with significant new capital and medium term horizon
Case Study: Hilding Anders continued

The outcome

• €350m PIK facility provided to the company by KKR
• Net cash pay leverage reduced from 8.1x to 4.9x
• Comprehensive amend and extend achieved
• KKR joins the board in partnership with Arle

Challenges

• High total leverage
• Large quantum of debt required
• Need for bilateral negotiation given very bespoke structure and governance
• Hard to predict high yield market
• Requirement for amend and extend on remaining senior debt
Case Study: URSA

Company summary

- Leading European manufacturer of insulation building materials (Glass Wool and XPS)
- Headquartered in Madrid but European footprint with limited exposure to Spanish construction
- Revenues and EBITDA of €445m and €55m
- URSA is 100% owned by Uralita S.A.
- Uralita is 80% owned by Nefinsa

Reasons for needing direct lending

- Following the downturn from 2008, construction markets across Western Europe have been significantly impacted
- URSA’s corporate parent Uralita, has been materially affected by incremental decline in Spanish construction
- After recent earnings declines, Uralita struggled to meet its debt obligations
- Current lenders were unwilling to provide additional liquidity in light of their own capital constraints
- Existing lenders were unwilling to extend their debt maturities in light of new Spanish regulations on provisioning
Case Study: URSA continued

The outcome

• €320m 7 year financing underwritten by KKR with PF leverage at closing of ~6.5x
• Proceeds from financings used for subpar repayment of existing lenders – both banks and note holders
• URSA now well capitalised to develop pan-European insulation business
• Capstone helping on the operational turnaround

Challenges

• Required interim financing pre-closing (KKR provided receivables facility)
• Some lenders were obstructive and KKR engineered solution through a quasi-discounted exchange offer
• Large quantum of debt required
• High total leverage
• Need for bilateral negotiation given very bespoke structure
General themes and lessons

• Many high quality businesses have inappropriate capital structures
• To be a real solution you need to be able to speak for large quantities – would have been too difficult to put together a club in either case
• Deals take time to put together and require significant resources
• In depth diligence necessary to see beyond the headlines
• Long term approach required
• Governance structure important
• Partnership with other stakeholders essential
The institutionalisation of Europe’s direct lending space - Opportunities and risks

Chairperson: David Bell, Managing Director, BNY Mellon
Dhruv Sharma, Director, Asset Selection, Strategic Asset Partners
Pascal Meysson, Direct Lending & Mezzanine, Alcentra
Christophe Vuilliez, Managing Director, Private Debt, Ardian (AXA Private Equity)
Lucette Yvernault, Euro Credit Fund Manager, Schroders
What are the key considerations for managers when structuring direct lending vehicles?

Aron Joy
Managing Associate
Simmons & Simmons
What are the key considerations for managers when structuring direct lending vehicles?

Aron Joy

13 November 2013
Aspects to be covered:

- Fund vehicle: partnership or corporate?
- Tax considerations: investors, the Fund and investments
- Regulation and shadow banking
- AIFMD and marketing
- FATCA
- Other developments/considerations, e.g. BEPS and FTT
Fund vehicle: partnership or corporate?

Corporate structure

Advantages:
- Simplicity
- Cost and timing benefit
- Relatively straightforward listing

Disadvantages:
- Does not easily accommodate carry treatment
- Does not fit drawdown and related mechanisms as easily
- May be less familiar to some investors
- Query suitability for both US taxable and US tax exempt investors
Fund vehicle: partnership or corporate?
Partnership structure
Fund vehicle: partnership or corporate?

Partnership structure

Advantages:

- A common structure for closed-ended funds
- Offers greater flexibility as to drawdown and related mechanisms
- Allows principals to receive carry rather than performance fee
- Feeder structure accommodates US taxable and tax exempt investors

Disadvantages:

- Greater complexity and therefore cost/time to execution
- Investors may seek to negotiate partnership terms more readily
- Does not offer an easy route to listing
- May cause Bank Holding Company Act/US and UK regulatory issues for manager/adviser given ownership and control of GPCo

But: familiarity is an important factor…
And: tax considerations also a driver (see below)
Structuring: tax considerations

Need to take into account tax considerations at three levels:

1. tax position of investors
2. tax position of the Fund itself
3. tax position of investments by the Fund
Tax position of investors

- No additional tax liabilities that would not be suffered by investors were they to invest directly in underlying

- Cannot anticipate the tax profile of a particular investor

- But consider the following general points:
  
  a) Are investors subject to tax and is their tax liability greater than for a direct investment?

  b) Do the investors qualify for any tax regime, e.g. pension funds, insurance companies or collective investment schemes?

  c) Anti-avoidance rules in the investors’ home jurisdictions?

  d) Level of tax reporting to allow investors to comply with their obligations?

  e) Can distributions and redemption proceeds be paid to investors without WHT or other taxes?

  f) Transfer or registration taxes on dealing by investors in their interests in the Fund?

  g) Tax filing and/or payment obligations in the jurisdiction of the Fund or its investments?
Tax position of the Fund itself

- Two basic models can be used:
  - structuring the Fund as a tax transparent entity
  - structuring the Fund as an effectively tax exempt entity

- Management of the Fund’s investments
Tax position of investments by the Fund

- Analysis on a case by case basis required but the principal considerations are:
  - Withholding taxes?
  - Double tax treaty protection and conduit/anti tax haven rules?
  - Will the Fund or investors be directly assessable to tax in the jurisdiction of investment?
  - Do the Fund or investors have tax filing obligations in the jurisdiction of investment?
  - Is particular information on investors needed e.g. for FATCA (see below)
  - Transfer or registration taxes in respect of investments?
Investment vehicles

- Primarily to mitigate WHT on interest
- Luxembourg, Ireland and the Netherlands are the usual suspects
- Could use a UK company
- Choice of vehicle
- Funding of vehicle
- Conduit issues
- Treaty relief application (and UK treaty passport scheme)
- Residence and permanent establishment risk (and IME)
Carry structuring?

- Need to preserve capital treatment of returns
- May therefore need additional vehicles and features, e.g. to avoid the UK offshore fund rules
- Need to use a tax transparent Fund entity
- BUT direct lending activity may mean carry is a more difficult starting position
Management or advisory structure?

- Tax: trading through a permanent establishment?
  
  Two main solutions:
  1. use an advisory structure
  2. investment manager exemption

- There may be similar issues in other jurisdictions

- Regulatory: Is there a desire to structure out of AIFMD?
  - Need to meet the letterbox test

- VAT
Regulation and shadow banking

- Desire to avoid regulation (at entity level) in the overall structure
- UK: provision of loans to UK borrowers not a regulated activity (provided credit is not extended to individuals)
- Luxembourg: securitisation companies cannot ordinarily originate
- But EU spotlight on shadow banking
- Seasoning structures
AIFMD

- Very broadly, AIFMD newly regulates:
  - managing of alternative investment funds (AIFs) by alternative investment fund managers (AIFMs)
  - marketing of AIFs in the EU by AIFMs (or persons acting on their behalf)

- AIFMD regulates AIFMs (as manager) but does not directly regulate AIFs
AIFMD

- AIFMD does not distinguish between Fund type
- Structuring out of AIFMD for managing purposes
  - managing an AIF does not include delegates of an AIF. NB the letterbox test
- Investment vehicles
- Broader restructuring of manager’s group?
Marketing

- Marketing outside the EU – it is likely that marketing and licensing requirements will apply and must be considered on a case by case basis

- Marketing within the EU – broadly speaking, marketing can only be done on the basis of:
  - reverse solicitation (unlikely)
  - transitional arrangements
  - under each Member State’s national placement rules

- Navigator
FATCA

- Really about information exchange to identify payments to US taxpayers
- FATCA withholding tax is the stick used to incentivise/enforce information exchange
- Intergovernmental agreements (IGAs) mean FATCA may not be a material issue
- Use an investment vehicle in a model 1 IGA jurisdiction
Other developments/considerations

- Base erosion and profit shifting (BEPS)
- FTT
- Real estate?
Resources: AIFMD microsite on elexica
Resources: FATCA microsite on elexica

FATCA

Overview
Implementation timeline
10 key facts for ...
Practical guides
IGA status table
Useful links and articles

Introduction

In 2010, the US enacted the Foreign Account Tax Compliance Act (FATCA), rules designed to use foreign financial institutions (FFIs) to combat tax evasion by US taxpayers with offshore investments. US Treasury regulations providing more-detailed FATCA rules have since been published and took effect from 22 January 2013. Notice 2013-34 subsequently confirmed revised timelines for FATCA implementation, to be reflected in amended regulations. The FATCA rules are wide-ranging and complex and will have a significant impact on non-US financial institutions and others from 1 July 2014, when its principal consequences are expected to come into effect.

In particular, FATCA imposes a 30% withholding tax on US-related payments made to FFIs unless they identify and annually report information on “financial accounts” held by specified US persons and foreign entities in which US persons hold a substantial (ie generally greater than 10%) interest:

- to the IRS under a FFI agreement entered into with the US or
- to their national tax authority or the IRS under national legislation implementing FATCA, where the FFI is in a jurisdiction that has entered into an intergovernmental agreement (IGA) with the US.

Non-US financial institutions for these purposes will include banks, securities brokers and dealers, custodians, clearing organisations, funds, asset managers, administrators and capital markets issuers.
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