M&G Debt Opportunities fund III

Addressee

This note has been prepared by Hymans Robertson for the Investment Sub-Committee of Leicestershire County Council Pension Fund (LCCPF).

Introduction and Proposal

M&G are in the process of launching their third distressed debt fund, the Debt Opportunities Fund (III). This note is designed to provide a detailed overview of the key characteristics for the Fund. This paper should not be released or otherwise disclosed to any other third party, except as required by law, or without our prior written consent. We accept no liability where the paper is used by, or released or otherwise disclosed to a third party unless we have expressly accepted such liability in writing.

LCCPF has already made an allocation of £35m to M&G's first Debt Opportunities Fund (DOFI) and a further £40m allocation to the manager's second Fund, DOFII. DOFI is fully invested with DOFII 64% drawn.

In order to maintain a rolling commitment to M&G's management of assets in this sector of the debt markets as DOFI begins to pay down, we suggest a commitment of £35m to £40m to DOF III would be appropriate.

Funding for DOFIII would come from DOFI distributions and the reduction in the Fund's commodity exposure (assuming any disinvestment occurs ahead of funding). To the extent this is insufficient to meet calls for cash, strategic funding should be from equities, which acts as the strategic balance to variation in the LCCPF Opportunity Pool allocation.

Firm Background

M&G investment management is a wholly owned subsidiary of the listed financial services group, Prudential. Fixed income is a vital part of firm's business, both externally and for the management of internal insurance assets and represent the vast majority of the assets under management. The firm's UK heritage has led to its success in managing assets for UK institutional clients. M&G employs one of the largest credit resources in the city across both the public and private debt markets. The debt restructuring team sits within the wider debt resource. Paul Taylor, head of the team, launched the first Debt Opportunities Fund in 2012, and the second in 2013.

Overview of the strategy

The launch of the Debt Opportunities Fund (III) follows the success of DOF I & II.

- The first fund which closed in June 2012 with €280m of commitments had a 2 year drawdown period. To date 100% of the committed capital has been drawn with 19 investments made in Europe. This month it is making its first distribution of capital to investors of €50m. The first fund's current performance, based on five realised investments and the expected return on current portfolio holdings, is well in excess of the 15% return target.

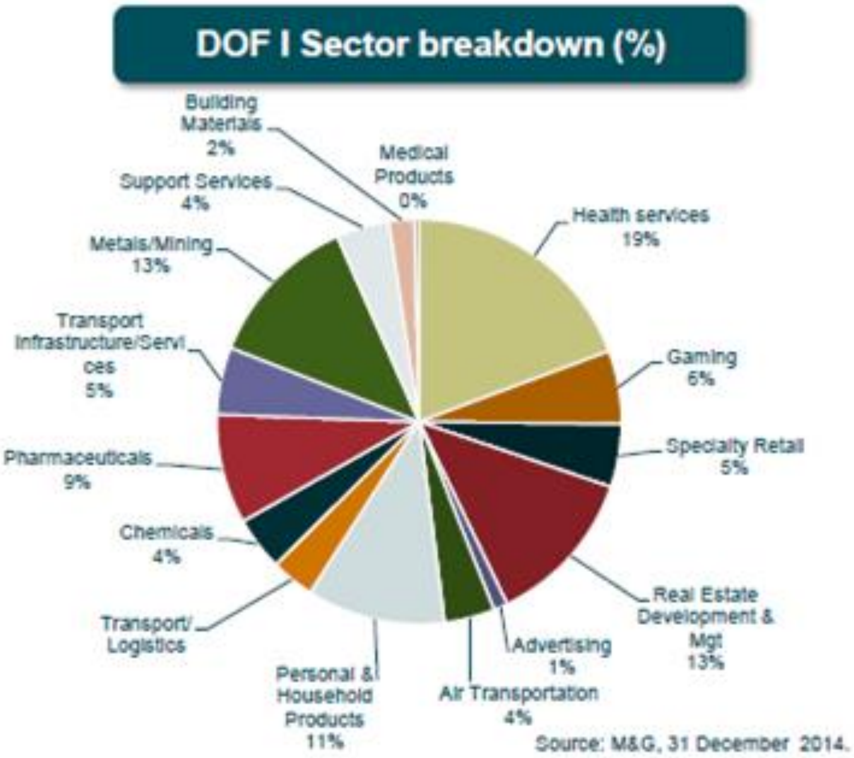
  The €50m distribution reflects the repayment or sale of 3 assets in the Fund. Two loans are being repaid early with internal rates of return of 22% and 109% gross of fees and charges. The third loan is being sold in the secondary market at an internal rate of return of 53% gross of fees and charges.

- The second fund closed in June 2014 with €300m of commitments and also has a 2 year drawdown period. 50% of commitments were drawn in the second half of 2014, and the fund is now 64% drawn.

Table 1: Snapshot of investments in Debt Opportunities Fund (I)

Company	Seller	Reason for Sale	Exit strategy	Target IRR
Alliance medical	Dubai International Capital	Forced sellers – due to lack of refinancing	Restructuring and sale of business	15%
Irish House Builder	Banks	Banks were forced sellers	Recapitalisation and restructuring of business	Current IRR 30%
Ground rent securitisation	Banks	Banks were forced sellers	Sold in secondary market	Returned 14.3%

Chart 1: Distribution of investments in Debt Opportunities Fund (I) (source M&G)



DOFIII will follow the same investment philosophy, investing in a concentrated portfolio of European distressed debt opportunities. Although there is no standard definition of what constitutes 'distressed' debt, it typically starts with the price. Distressed debt managers target bonds, loans and other financial claims which offer high levels of yield (>10%), often trading at a meaningful discount to their par value (>40%).

This discount might exist for numerous reasons. These include deterioration in the credit-worthiness of the borrower, perhaps due to its underlying business suffering, or uncertainty regarding a future requirement for re-financing or restructuring of the debt. Some might already be in reorganisation proceedings under bankruptcy law, with others perceived to be at material risk of being so. In these instances, investors rightly expect higher rates of return and running yields to compensate them for the elevated risks they face.

M&G's approach to distressed debt is value-driven. The team seek to identify and analyse companies where they believe - based on the valuation of the company and or its assets - the market is overly discounting the value of the debt.

The team do not consider themselves as activist investors (per se) in this space, but will get involved in the restructuring of companies, sitting on creditor boards and appointing interim new management where appropriate.

Key drivers for the strategy

The market environment for distressed debt is driven by a number of factors, most notable being:

- **Supply.** In contrast to most risk asset classes and strategies, distressed debt managers can find that difficult financial and economic conditions act in their favour, through increasing the supply and breadth of potential investments (of which only a very small proportion will ever be attractive) and the likelihood that current owners of this debt are willing to sell at heavily discounted prices. This potential for counter cyclicality is one of the most attractive aspects of the asset class.
- **Basel III implementation.** The key impacts of this regulation is an increase in capital requirements for banks, changes to the way counterparty risk is assessed and the re-rating of certain risk assets. All of which have added further pressure on European banks that have been deleveraging since the 2008 financial crisis.

  One of the resulting opportunities is the ability to purchase assets from banks at discounted prices (although this has been much slower to transpire than many initially though at the end of the financial crisis). It has also led to tighter credit conditions making it harder for companies to access financing which can lead to financial difficulties and as such investment opportunities.
- **Corporate balance sheet and working capital efficiency.** This has a much wider impact on corporates at this stage of the credit cycle compared to 2008-2009, when distressed opportunities where largely driven by overleveraged LBO companies

European focus

The uncertainty regarding the current macro-economic situation in the Eurozone might superficially draw into question the legitimacy of focusing on an investment in this region (rather than, for example, the US, or globally). However, we are comfortable with the Fund's European focus for three reasons.

Firstly, the investment is so security specific such that its outcome is unlikely to be primarily driven by broad economic outcomes, but rather the resolution of each specific debt situation. Some of the businesses involved are also likely to have meaningful business interests / revenue streams outside of Europe anyway.

Secondly, we regard the key to success in this fund as being the expertise brought by the investment manager and its knowledge of the underlying companies – M&G's European focus fits well here.

Finally, it will arguably be some of the Eurozone stresses (i.e. contraction in lending from Banks caused by ongoing deleveraging pressures) that will drive the scale of the opportunity set and their potential returns.

Overview of risk

The Fund faces the idiosyncratic and operational risks associated with individual securities, which are selected by the fund manager, Paul Taylor and his team. Security selection is vital to the success of the Fund, in particular, given the expected concentration of portfolio holding (between 10 – 20 securities). The high level of income and returns sought will provide little protection against outright loss form one or two poor decisions.

To mitigate losses the team adopts a risk averse, credit driven and disciplined approach to security selection. Each investment decision must meet a number of set criteria at both the financial and legal level.

The set criteria (checklist) include; ensuring the underlying business is sound, the supporting assets underpin a recovery, financial diligence confirms value, legal diligence confirms a clear path through restructuring, the ability for M&G to join the creditor committee or otherwise influence restructuring, a clear strategy for managing spoiling tactics from equity holders and other creditors, debt yield to maturity must be over 15% and finally there must be multiple ways to exit the position and unlock value.

We would note that success in security selection is not necessarily dependent on the overall macro-economic environment, good or bad. However, we would expect that widespread recovery in the coming years would act as a tailwind to the fund (to the extent that this had not reduced prospective returns through occurring during and / or prior to the investment period).

Strategic rationale

As a recap, we include in the Appendix to this note the strategic rationale for investing in the M&G Debt Opportunity Fund range.

In brief, we consider the M&G Debt Opportunities Funds an attractive diversifying growth strategy for those clients willing to withstand the illiquidity (5-7years).

It can be considered alongside other forms of higher risk lending, such as high yield bonds and loans. Although we might expect there to be a degree of correlation with the high yield bond and loan markets, the returns of distressed debt portfolios will be extremely security specific.

This is not an approach based simply on earning coupons / yield and avoiding default. Instead, successful investing is heavily reliant on having debt restructuring expertise, which may involve some level of activism, and understanding different European jurisdiction is critical.

Key features of the proposed investment

Key features of this fund are similar to previous funds, namely:

- The fund invests in the debt of underperforming, stressed or distressed UK and European issuers
- Target return; minimum of 15% p.a. net of all fees
- No leverage will be used in the fund
- The fund has a 5 year term (with options to extend to 7 years)
- Drawdowns will be spread over the initial investment period of up to 2 years
- Investments; 10-20 names (max 15% of commitments to a single name)
- Size of Fund: Target fund size is €750m
- Should be viewed as illiquid for the entire term

Our overall view

We think there is a strong case for employing M&G as a distressed debt manager and support an investment in the managers Debt Opportunities Fund (III). This recommendation is based on both the manager’s ability in distressed debt investing on a standalone basis and its competitive position over alternative investors.

On a standalone basis, the team has provided reasonable evidence of demonstrable experience and track record in dealing with similar investments in the past, initially investing for its own Life book of assets, before launching an external fund in 2012. It has also shown sufficient due diligence resource, with a team of credible restructuring specialists and large private and public credit research teams.

In terms of its competitors, M&G's position as a leading debt investor (both for external investors and its own Life Fund) provides it with a competitive edge in this area.

Firstly, the exposure and information gained on underlying borrowers by M&G through its current debt and/or equity investments (e.g. within its Life Funds) will be critical in identifying opportunities.

Secondly, M&G's ownership of debt outside of the Debt Opportunity Fund's assets is important in establishing control during any restructuring (in many instances, M&G will, in aggregate, own 25% or more of the debt capital / instrument involved).

Finally, subject to appropriate arrangements as to equal treatment of the different investors, we regard the common ownership of M&G with the Fund as being attractive in terms of aligning interests.

Prepared by:-

Andy Green, Partner

Alison Clark, Research Consultant

Claire Ballantyne, Bond Research Consultant

For and on behalf of Hymans Robertson

April 2015

General Risk Warning

Appendix

Strategic rationale for investing in M&G Diversified Opportunity Funds

We consider the M&G Debt Opportunities Fund III as an attractive diversifying growth strategy for those clients willing to withstand the illiquidity (5-7years).

- It could be considered alongside other forms of higher risk lending, such as high yield bonds and loans. Although we might expect there to be a degree of correlation with the high yield bond and loan markets, the returns of distressed debt portfolios will be extremely security specific, depending on the success or otherwise of the managers' sourcing, due diligence and restructuring activities, etc. This is not an approach based simply on earning coupons / yield and avoiding default. Instead, successful investing is heavily reliant on having debt restructuring expertise, which may involve some level of activism.
- Distressed debt remains a 'niche' strategy, accessed by only a small proportion of the institutional investor market. Whilst the number of market participants is growing, investments are often made through private transactions and therefore not widely available to the broader investment management industry.
- There is a valid investment thesis for the distressed debt opportunity set, particularly in Europe. Increasingly stringent regulatory requirements will continue to place pressure on banks to de-lever combined with difficult economic conditions which should increase the supply and breadth of potential investments (of which only a very small proportion will ever be attractive). Despite the increased ECB support, the sluggish economic recovery in Europe will challenge poorly capitalised corporates.
- Given the often private nature of distressed investing there tends to be a restricted (if any) secondary market. Therefore, the timing of exit or sale of the underlying securities can be an important determinant of total returns. Clients face the risk that the macro-environment during any 1-2 year window is not conducive to selling risky assets. However, we are comfortable with this risk given the strategy is not heavily reliant on the existence of a secondary market to exit positions. But rather clients' capital will be returned through the debt maturing and / or through the restructuring process resulting in the debt being repaid prior to maturity.
- Perhaps the greatest hurdle to demand from potential investors in this market is transparency and governance. Investors must rely on the skill of the investment manager in accessing deals and in the market environment being such that enough attractive opportunities are available. We believe that M&G has a proven track-record investing in this market and will continue to find attractive investment opportunities though out credit cycles through a combination of the firm's extensive knowledge of the market and its reputations of being one of the largest credit managers for both its internal and external client base.