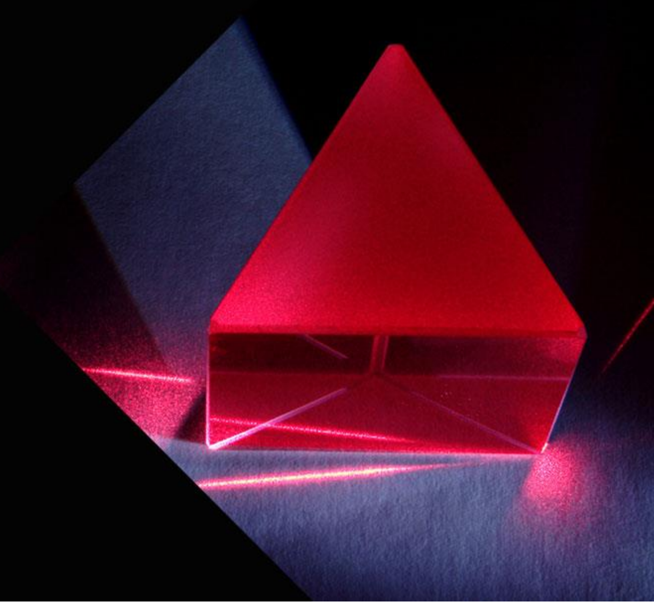
HSBC Asset Management



Accessing bank-originated assets: potential returns and diversification benefits

April 2024

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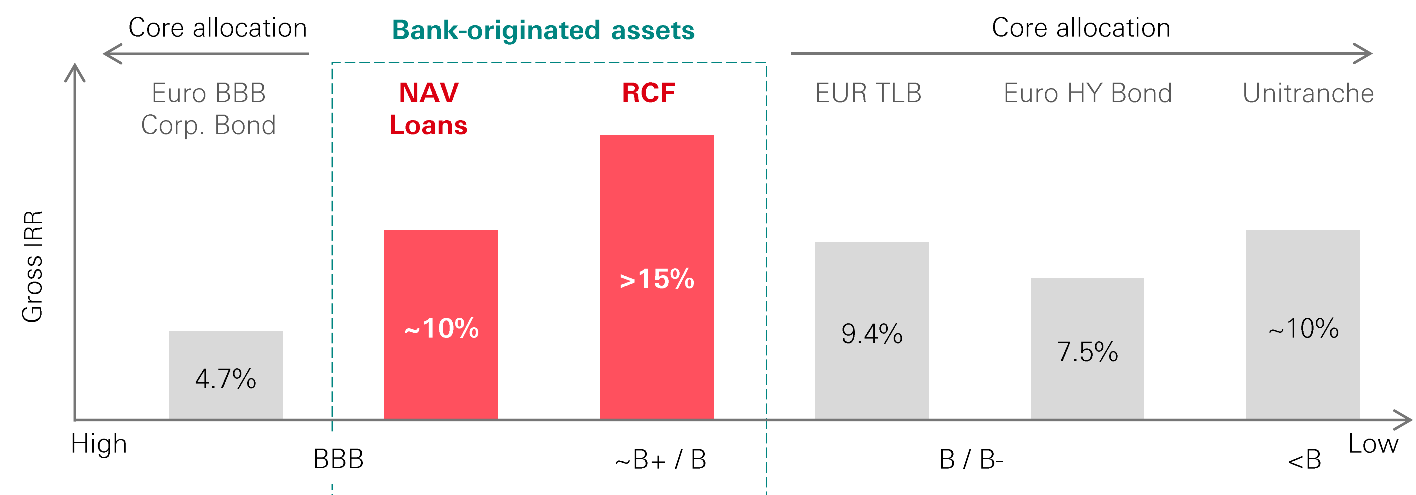
Bank-originated assets – background

For decades, banks have developed large and complex platforms to originate, underwrite and manage credit assets for a diverse range of corporate borrowers. In our view, many bank-originated assets – like Revolving Credit Facilities (RCF) and Net Asset Value (NAV) financing – can offer appealing returns and a resilient risk-profile if compared with traditional private credit core allocations. However, they have traditionally required the extensive origination and operational platforms that only banks could effectively manage and have therefore not been accessible to mainstream external institutional investors for a long time.

Comparison of bank-originated assets with traditional private credit allocations across the rating spectrum[1]



	Euro BBB Corp. Bond	NAV Loans	RCF	EUR TLB	Euro HY Bond	Unitranche
Size	Large cap	Mid cap	Large cap	Large cap	Large cap	Mid cap
Competition	Very high	Med	Low	High	Very high	Very high
Base rate exposure	High	Med	Low	Med-high	Med-high	Med

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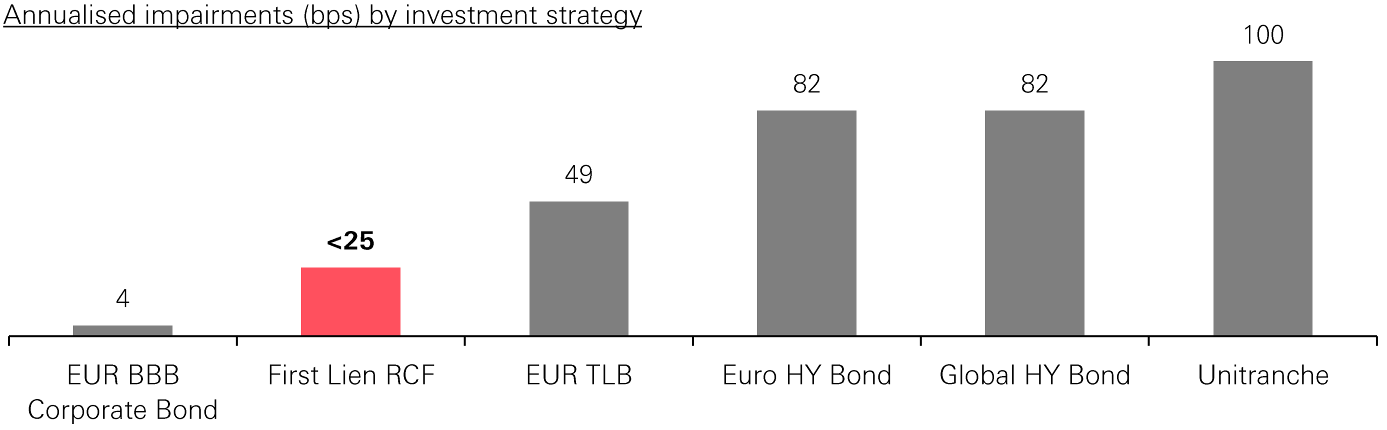
1. Gross IRR for comparable credit investments as per Bloomberg indexes and LCD ELLI index as of Mar-24. Returns for illustrative purposes only

RCFs, a growing and potentially attractive private credit vertical

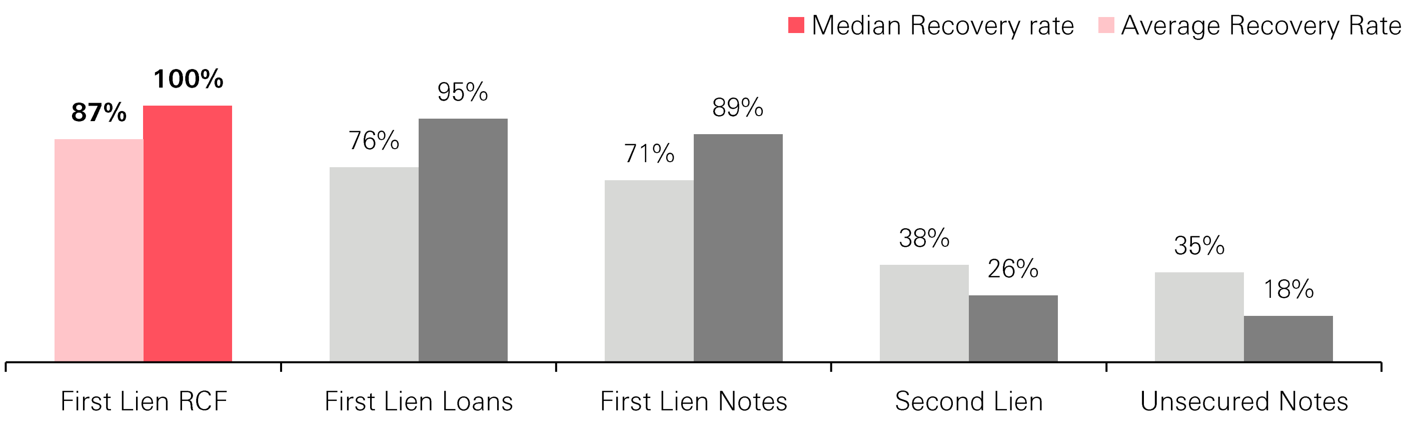
RCFs are bank-originated floating rate corporate loans allowing companies to borrow, repay and borrow again up to a set credit limit, until the facility matures. Given their provision of committed operational liquidity, RCFs are a tool for real-economy businesses to manage their corporate treasury and have therefore proven to be a resilient credit investment through economic cycles.

RCFs offer a resilient credit profile tested through the cycle[2,3]

Annualised impairments (bps) by investment strategy



2003-2022 average recovery rates by claim seniority



As an asset class, RCFs are usually only partially drawn by the borrowers. The majority of the commitment is maintained undrawn as a source of back-up liquidity which in normal market conditions is not required. Historical evidence from the European leveraged market shows that RCFs are generally drawn c. 20-30% in normal market conditions, with spikes to 50-60% only evidenced in periods of economic distress[4]. High drawing percentages above the 20-30% historical average tend however to last for short periods of time only, as RCFs are short term liquidity instruments.

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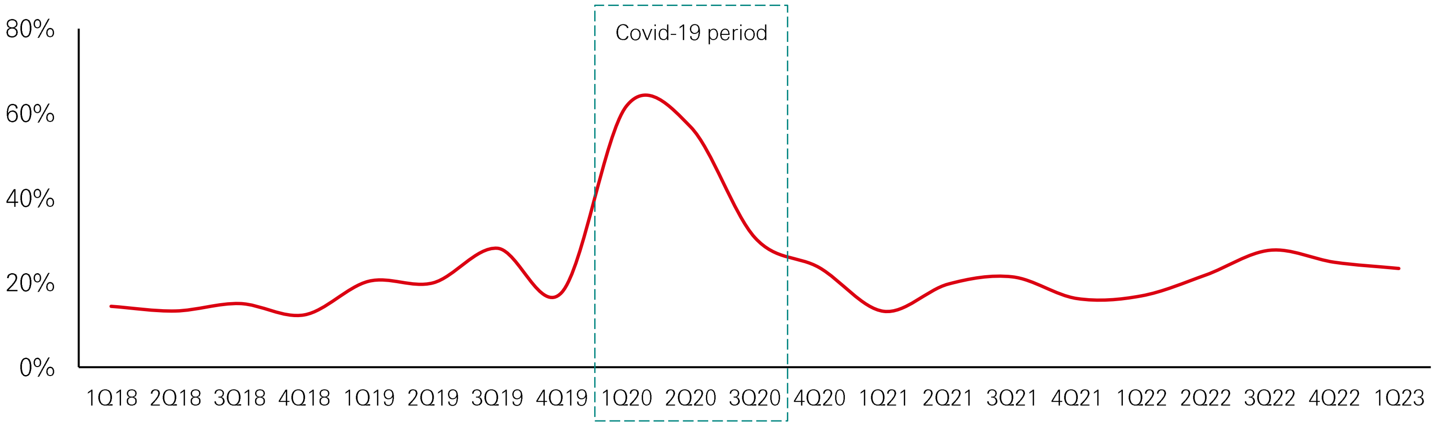
2. S&P Apr-22 Global Annual Corporate Default Rate publication. Impairments based on applying an 80% recovery rate to S&P default rate stats from 1981-2021 by credit rating band. HY Bond based on B rated data. Institutional TLB data based on a blended BB / B pool. RCF strategy impairments based on losses across HSBC's existing mid-markets financial sponsors loan book across UK and France
3. Mar-23 Fitch Ratings US Leveraged Finance Restructuring Report: 2003-2022 bankruptcy dataset
4. HSBC Continental Europe sampled portfolio as at Mar-23

Historical European RCFs drawing levels have remained stable through cycles[4]

<u>Sampled Continental Europe Leveraged Credit RCF Portfolio historical drawing level</u>



Limited drawing levels provide an additional layer of credit protection to RCF investors. This is evidenced by higher historical recovery rates with respect to comparable funded debt instruments in the market. At default, RCFs tend not to be entirely drawn (80% based on S&P methodology), which results in a higher recoverable amount and reduced credit risk.

A potentially attractive feature for investors is that RCFs can generate economics on the entire size of the facility despite only being partially drawn on average. This is because the borrowers also pay commitment fees on the available but undrawn portion of the RCF. As a result, there are potential benefits for RCF investors. Firstly, RCF strategies can limit the capital called from investors to the average RCF drawings across the portfolio. Secondly, lower capital called can result in enhanced returns for investors.

When properly underwritten and structured, in our view, sub-IG-RCF strategies can generate returns comparable or superior to mid-market direct lending, but with larger corporate borrowers which are often considered to represent lower credit risk given larger scale, geographical diversification and large, strongly capitalised private equity sponsors. These high-quality borrowers can provide diversification to traditional mid-market direct lending strategies.

RCFs can offer a potentially attractive return with a strong risk profile[5,2]

	Sub IG RCF	Euro BBB Corp. Bond	Euro HY Bond	Global HY Bond	EUR TLB	Unitranche (Euro)
Gross IRR	**>15%**	4.7%	7.5%	8.8%	9.4%	~10%
Capital deployed	**~20% (Typically)**	100%	100%	100%	100%	100%
Impairments	**<25bps (on drawn balance only)**	4bps	82bps	82bps	49bps	100bps
EBITDA ($)	**>100m / 1bn**	>1,000m	>100m	>100m	>100m	50m – 100m

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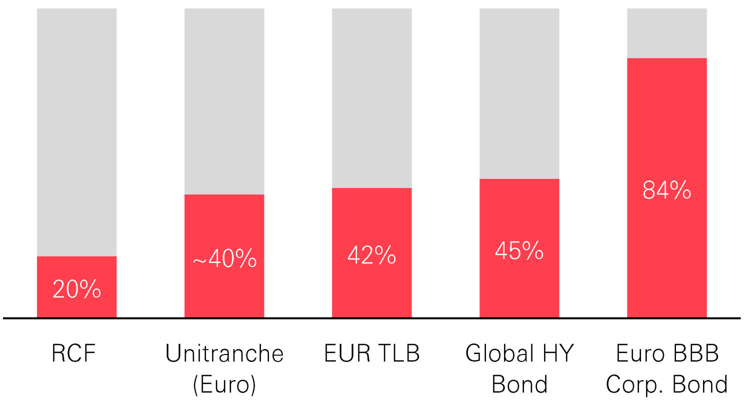
5. IRR for comparable credit investments as per Bloomberg indexes and LCD ELLI index as of Mar-24

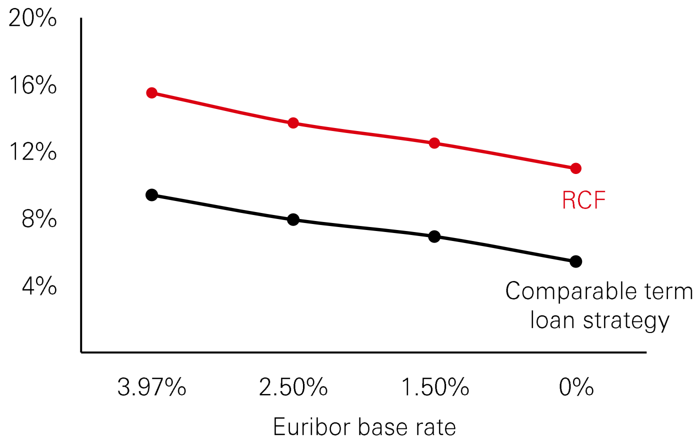
Critically, RCF strategies can help investors diversify base rate risk exposure in their existing core private credit allocations. Due to market supply/demand dynamics, RCFs capture upfront illiquidity premium, which can enhance returns and combined with other fee components, can also reduce exposure to base rate fluctuations.

RCFs' returns can have lower exposure to interest rate risk than comparable strategies[6]

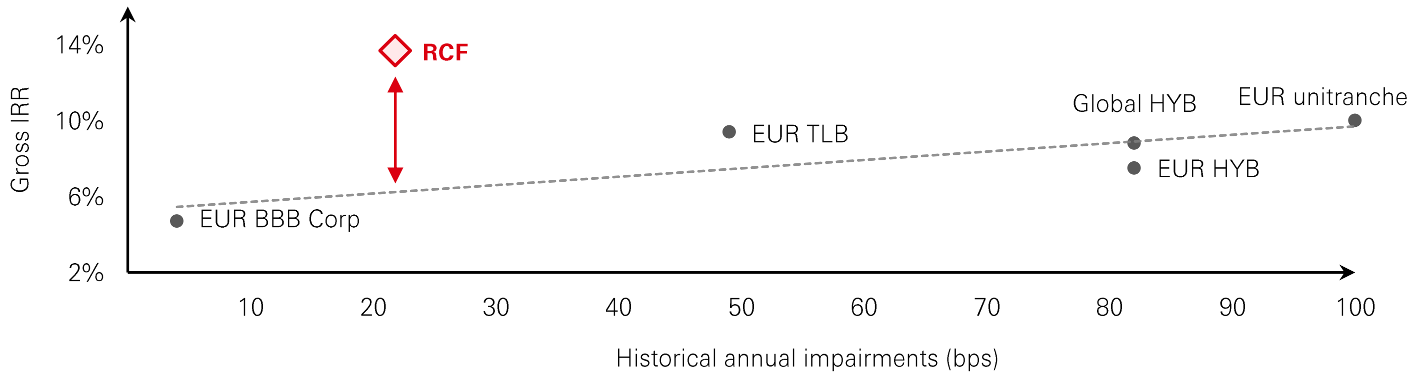
Exposure to interest rate risk by asset class (%)



Net IRR sensitivity to decreasing base rate



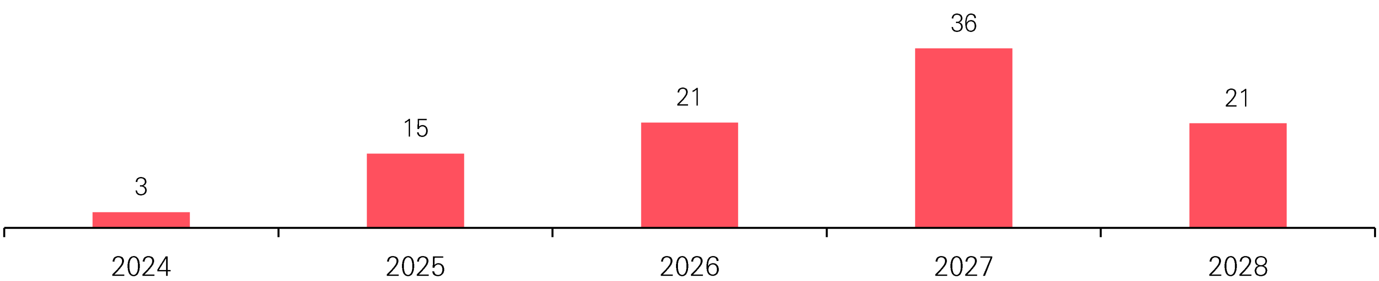
Sub IG RCF strategy positioning in the risk / return credit spectrum[5,2]



In our view, the RCF asset class has the potential to become a large and fast-growing private credit vertical, with ~$20BN private equity-backed corporate RCFs refinanced in Europe every year on average. Market structure changes and an evolving bank regulatory environment are likely to further support this trend, providing investors large, scalable and potentially attractive deployment opportunity while supporting real economy businesses.

Sub IG RCF – a large and scalable deployment opportunity

Expected refinancing wall in sub-IG European RCFs[7] (€bn)



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6. EUR BBB Corporate Bond, Global HY Bond and EUR TLB % split based on current yield as of Mar-23 and Euribor base rate of 3.97%
7. HSBC Asset Management estimate as at March 2024, based on upcoming maturities for TLB and HYB and relative size of RCF vs. total secured debt (based on information from LCD and Bloomberg). Any forecast, projection or target when provided is indicative only and is not guaranteed in any way.

Key Risks

Risk considerations: there is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may be subject to certain additional risks, which should be considered carefully along with their investment objectives and fees.

- **Illiquidity:** an investment in alternatives is a long-term illiquid investment. By their nature, the alternatives' investments will not generally be exchange traded. These investments will be illiquid.
- **Long-term horizon:** investors should expect to be locked-in for the full term of the investment.
- **Technological risk** exists when the technology, on the scale proposed for the project, will not perform according to specifications or will become prematurely obsolete. The risk of technical obsolescence following completion becomes particularly important when a project involves a state-of-the-art technology in an industry whose technology is rapidly evolving.
- **Economic conditions:** the economic cycle and prevailing interest rates will impact the attractiveness of the underlying investments. Economic activity and sentiment also impacts the performance of underlying companies and will have a direct bearing on the ability of companies to keep up with interest and principal repayments.
- **Valuation:** these investments may have no or a limited liquid market, and other investments including those in respect of loans and securities of private companies, may be based on estimates which cannot be marked to market until sale. The valuation of the underlying investments is therefore inherently opaque.
- **Strategy risk:** : Investments into alternatives may, among other risks, be negatively affected by adverse regulatory developments or reform, credit risk and counterparty risk. The credit market bears idiosyncratic risks such as borrower fraud, borrower bankruptcy, prepayment risk, security enforceability risk, subordination risk and lender liability risk.
- **Political and economic risks:** General economic conditions may affect the activities. Changes in economic conditions, including, for example, inflation, unemployment, competition, technological developments, political events and other factors, none of which will be within the control of the General Partner or the service providers, can substantially and adversely affect the business and prospect investors. Due to the geographic scope of its activities, the strategy may be vulnerable to country or regional-specific political, macroeconomic and financial environments or circumstances.
- **Investor's capital at risk:** Investors may lose the entirety of invested capital.

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