# Quarterly Update: Private Debt Fund 123

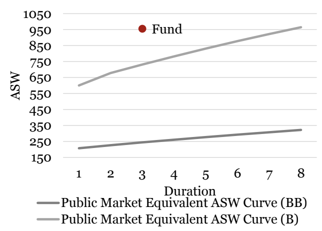
21. January 2021/KUP&MEM

| | |
|---|---|
| Markets: Europe (focus GR and AT) | Ø Rating of investments: BB- |
| Sectors: Consumer Service, Healthcare, Real Estate | Ø IRR (Forecast): 7.5% |
| Invested capital / average IC: EUR 1'966m / EUR 47.5m | Ø ESG Score: 67.6 |

## Conclusion

- Given the challenging macroeconomic environment due to Covid-19 related restrictions, the portfolio shows a robust performance. However, there are some investments with considerable difficulties. We expect persistent pressure on Company 5 and therefore see an unrealised value of EUR 50m at risk
- Deal flow was weak in 1H20 but is expected to pick up in the coming quarters
- There has not been any defaults so far and new investments are selected in line with the fund's strategy

Figure 1: Relative Value




## Description Funds Profile

**Private Debt Fund 123** (FUND123) invests mainly in software, business services, healthcare, and education-related companies with a regional focus on Germany, Austria and Norway. The investment focus is on companies with recurring revenue streams and high barriers to entry. Main investment types are unitranche LBO, acquisitions, and refinancing instruments. Relative to the inherent risks the expected return of the fund is more than adequate.

## Development of deal flow in 2Q20

On 9 July 2020, FUND123 reported the closing of its sixteenth investment (NewCOMP; Invested Amount: EUR 25.6m). The investment is in line with recent transactions as NewCOMP is a leading European distributor of healthcare supplies with strong EBITDA to cashflow conversion.

In 2H19 and 1H20, FUND123 has successfully exited three investments with an average gross IRR of approximately 9.5%. The fund is currently at 80% invested and 95% committed. Due to COVID-19, sourcing of new investments remains challenging (less LBO/MBO activity). In the last twelve months the team has reviewed 336 opportunities 57 thereof in 1H20. However, management expects an increase in deal flow in 2H20.

## Duration Risk

The expected duration is based on the target exit date of each transaction which is approximately four years after the loan agreement. The current average expected duration of the portfolio is less than three years. Therefore, the duration risk of the fund is limited. The maturity profile of the fund remains broadly diversified, which reduces the reinvestment risk.

## Evaluation of Default Risk in Portfolio

To date, there has not been any defaults in the portfolio. The majority of portfolio holdings have demonstrated robustness to Covid-19 impacts in 1H20. However, **Company 5**, which already reported weak results in 2018 (reflected in the collapse of its asset cover in Table 2), has come under even more pressure due to Covid-19. Thanks to equity injections and cost measurers, the company has sufficient liquidity for the coming quarters. Nevertheless, we expect FUND123 to closely monitor this credit since Company 5's probability of default implies a CC rating.

**Company 3** had to close its facilities for several months. Operating performance remains solid, reflected by a high EBITDA margin of 27.6% (YtD). However, this strong operating performance is, to some extent, a consequence of German government indemnities. We expect mounting pressure on revenue in coming quarters as government support runs out and the impact of Covid-19 restrictions will start to show in operating metrics. Probability of default has increased accordingly with the model implied rating currently at CCC.

In comparison to 1Q20, median leverage of the portfolio increased to 5.2x EBITDA (1Q20: 5.1x) and median asset cover decreased to 234% (1Q20: 242%). The average rating of the investments remains at BB- (1Q20: BB-).

## I-CV ESG Proxy Scores

The lowest I-CV ESG Proxy Scores are linked to portfolio companies within the software & services sector (Company 6, Company 7, Company 11) as well as the real estate industry (Company 2, Company 10). Whereas adjustments for controversies are the main negative driver for software & services companies, real estate companies are penalized by a low average sector score. ESG leaders are portfolio companies in the healthcare equipment & services industry domiciled in France (Company 15, Company 22, Company 25).



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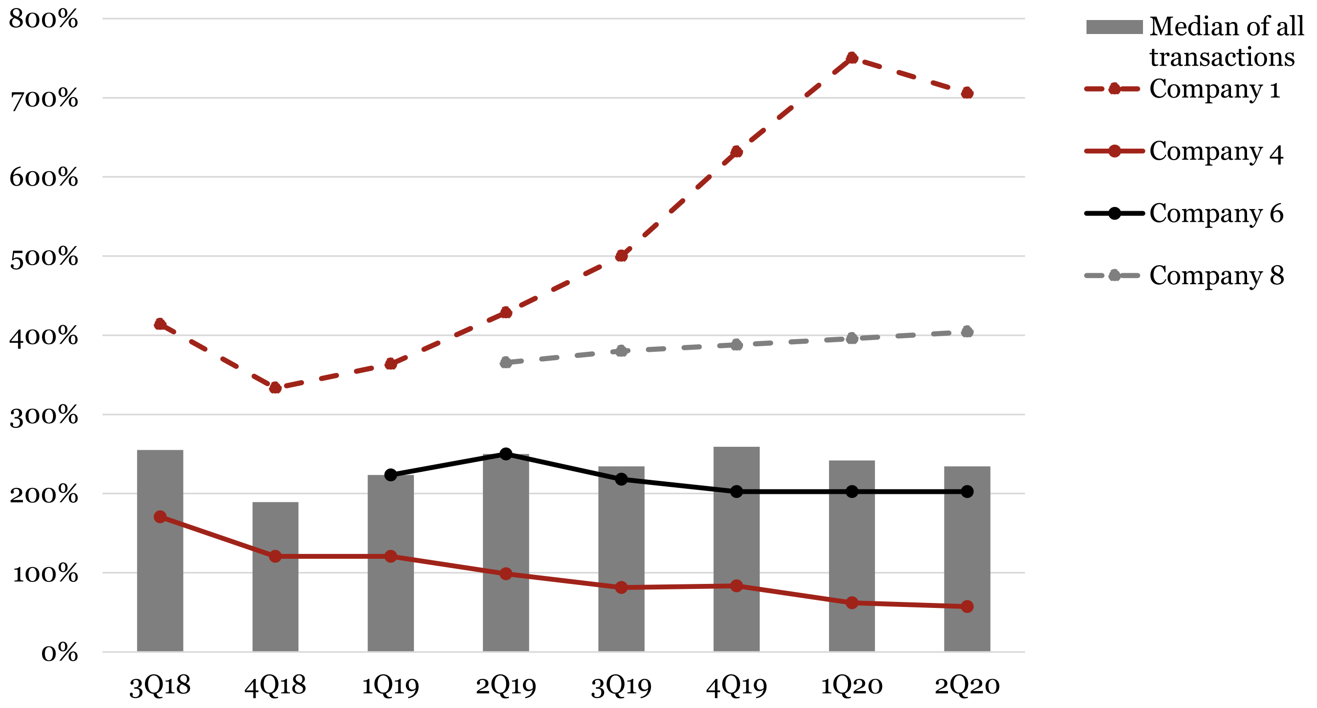
## Table 1: Overview of portfolio holdings as of 30.6.2020

| Company | Short Description | Country | Sector | Expected Maturity / Assumed Duration | | Unrealised Value | Current Leverage | EBITDA Margin (YtD) | I-CV ESG Proxy Score | Model Implied Rating (Probability of Default) |
|---|---|---|---|---|---|---|---|---|---|---|
| Company 1 | Description 1 | Country 1 | Integrated Telecommunication Services | 30. 9. 20 | 0.5 | 35 | 1.8 | 14.8% | 60.0 | BBB (1.1%) |
| Company 2 | Description 2 | Country 2 | Application Software | 20. 10. 20 | 0.8 | 51 | 6.5 | 17.0% | 59.2 | B- (12.9%) |
| Company 3 | Description 3 | Country 3 | Real Estate Development | 31. 12. 20 | 0.5 | 55 | 2.5 | 15.1% | 59.9 | BBB+ (<1%) |
| Company 4 | Description 4 | Country 4 | Health Care Distributors | 30. 6. 21 | 0.5 | 22 | 10.2 | -2.5% | 64.1 | CC (71.8%) |
| Company 5 | Description 5 | Country 5 | Health Care Equipment | 31. 12. 21 | 0.9 | 55 | 6 | 26.0% | 64.1 | B- (11.4%) |
| Company 6 | Description 6 | Country 6 | Leisure Facilities | 31. 1. 22 | 1.0 | 34 | 4.2 | 27.0% | 62.4 | CCC (25.4%) |
| Company 7 | Description 7 | Country 7 | Health Care Services | 28. 2. 22 | 1.1 | 20 | 6.5 | 15.6% | 62.9 | BB (2.3%) |
| Company 8 | Description 8 | Country 8 | Application Software | 30. 4. 22 | 1.3 | 20 | 4.7 | 48.1% | 59.2 | BBB+ (<1%) |
| Company 9 | Description 9 | Country 9 | Application Software | 30. 4. 22 | 1.3 | 50 | 4.5 | 54.0% | 59.2 | BBB+ (<1%) |
| Company 10 | Description 10 | Country 10 | Health Care Services | 31. 7. 22 | 1.5 | 57 | 6 | 19.9% | 67.0 | BBB+ (<1%) |
| Company 11 | Description 11 | Country 11 | Diversified Real Estate Activities | 30. 9. 22 | 1.7 | 82 | 5 | 7.6% | 75.0 | B+ (4.7%) |
| Company 12 | Description 12 | Country 12 | Health Care Services | 31. 12. 22 | 1.9 | 95 | 4 | 20.8% | 67.0 | B- (12.9%) |
| Company 13 | Description 13 | Country 13 | Health Care Equipment | 30. 6. 23 | 2.4 | 22 | | | 65.0 | |
| Total (Median / Average) | | | | | 1.4 | 598 | 4.9 | 18.5% | 62.7 | BB |

Sources: Company data and I-CV

Figure 2: Development of Asset Cover




Sources: Company data and I-CV



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## Appendix: Methodology

**Model implied rating:** The model implied rating is based on a Merton distance to default model which uses option pricing theory and considers a company's equity as a call option on its assets. Key input factors are the volatility of EBITDA, the asset cover, the expected return of the portfolio companies, as well as soft factors.

To estimate the volatility of assets, historical observations of EBITDA volatilities are used as a starting point. Additionally, to account for differences in the companies' business risk profiles, soft factors (which impact the volatility of assets) such as diversification, customer quality, market position, midterm business outlook, and supportive ownership are incorporated into the volatility estimate. These soft factors are evaluated on a quarterly basis by I-CV sector analysts and are therefore subjective in nature.

### Table 2: I-CV analyst assessment (scorecard)

| 2 = very strong<br>0 = neutral<br>-2 = very weak | Geographic Diversification | Product Diversification | Customer Diversification | Customer Quality | Macroeconomic in Core Markets | Market Position | Midterm Business Outlook | Support from Sponsor / Owner |
|---|---|---|---|---|---|---|---|---|
| Company 1 | -1 | -1 | 1 | -1 | 0 | 0 | 0 | -1 |
| Company 2 | -1 | 0 | 1 | 1 | 0 | 1 | 1 | 0 |
| Company 3 | 0 | -1 | 2 | 0 | 0 | 1 | -1 | 0 |
| Company 4 | -1 | -1 | 1 | 1 | 0 | -1 | -2 | 2 |
| Company 5 | -1 | 0 | 1 | 1 | 0 | 0 | 0 | 0 |
| Company 6 | -1 | -2 | 2 | -1 | 0 | -1 | -2 | 0 |
| Company 7 | -1 | -2 | -2 | 2 | 0 | 1 | 0 | 0 |
| Company 8 | -1 | -1 | 1 | 1 | 0 | 1 | 1 | 0 |
| Company 9 | -1 | -1 | 0 | 1 | 0 | 1 | 0 | 0 |
| Company 10 | -1 | -2 | -2 | 2 | 0 | 1 | 0 | 0 |
| Company 11 | -1 | -1 | 0 | -1 | 0 | -1 | -1 | 0 |
| Company 12 | -1 | -2 | -1 | 2 | 0 | 1 | 0 | 1 |
| Company 13 | 1 | 0 | 1 | 0 | 0 | 1 | 0 | 0 |
| Company 14 | -1 | -1 | 2 | 0 | 0 | 0 | 0 | 0 |
| Company 15 | -1 | -1 | 1 | 0 | 0 | 1 | 1 | 0 |

Sources: Company data and I-CV

The relationship between asset volatility, volatility of EBITDA, and soft factors can be expressed as:

$$\sigma_A = \sigma_{EBITDA} + soft\ factor\ implied\ volatility$$

In order to calculate the distance to default, also Asset Cover and the expected returns (as a drift parameter) are required. Asset Cover is defined as:

$$Asset\ Cover = \frac{Enterprise\ Value}{Net\ Debt}$$

The enterprise value of each portfolio company is estimated by multiplying sustainable EBITDA-Levels (estimated by I-CV analysts) with a public market equivalent multiple (estimated by I-CV analysts based on peer group observations). As liability threshold/default point, net liabilities are used. Net debt is calculated based on reported leverage and sustainable EBITDA levels. Expected returns are chosen to meet historically achieved private debt returns as well as currently expected levels.

With the above described input factors and the assumption of lognormal distributed asset returns, the distance to default (DD) and, ultimately, the probability of default (PD) for each portfolio company can be estimated by:

$$DD = \frac{log(Asset\ Cover) + (expected\ return - \sigma_A^2/2)}{\sigma_A}$$

$$PD = 1 - N(DD)$$

However, one has to keep in mind that loss given default of private debt investments (especially unitranche investments) is much lower in comparison to public market transactions (renegotiations are common). Therefore, to arrive at a meaningful estimate for the expected loss, the model implied probability of default must not be considered in isolation.

**I-CV ESG Proxy Score:** Since private debt companies are not listed, I-CV cannot source company specific ESG data from its data warehouse. Therefore, I-CV applies an ESG proxy scoring methodology which is based on the company's industry sector and its key markets. To calculate an I-CV ESG Proxy Score, I-CV combines sector average I-CV ESG Raw Scores (scores before adjusting for geographic footprint) and I-CV ESG Controversies Adjustments, based on ca. 630 relevant debt issuers, with the I-CV ESG Country Score of the relevant market:

$$I\text{–}\ CV\ ESG\ Proxy\ Score = w * \emptyset(I\text{–}\ CV\ ESG\ Raw\ Score) + (1-w) * I\text{–}\ CV\ ESG\ Country\ Score + \emptyset(I\text{–}\ CV\ ESG\ Controversies\ Adj.)$$

### Table 3: Calculation of I-CV ESG Proxy Scores

| Company | Country for ESG Proxy | Sector for ESG Proxy | I-CV ESG Proxy Score | GICS_ESG_Controversies _Adjustment | I-CV ESG Proxy Footprint-adj. Score | CountryESG | GICS_ESGRaw |
|---|---|---|---|---|---|---|---|
| Company 1 | Great Britain | Telecommunication Services | 59.99 | -4.41 | 64.40 | 64.09 | 64.7 |
| Company 2 | Great Britain | Software & Services | 59.21 | -4.47 | 63.68 | 64.09 | 63.27 |
| Company 3 | France | Real Estate | 59.92 | -0.42 | 60.34 | 66.48 | 54.2 |
| Company 4 | France | Health Care Equipment & Services | 64.12 | -3.56 | 67.68 | 66.48 | 68.88 |
| Company 5 | France | Health Care Equipment & Services | 64.12 | -3.56 | 67.68 | 66.48 | 68.88 |
| Company 6 | France | Consumer Services | 62.38 | -6.33 | 68.71 | 66.48 | 70.93 |
| Company 7 | Great Britain | Health Care Equipment & Services | 62.93 | -3.56 | 66.49 | 64.09 | 68.88 |
| Company 8 | Great Britain | Software & Services | 59.21 | -4.47 | 63.68 | 64.09 | 63.27 |
| Company 9 | Great Britain | Software & Services | 59.21 | -4.47 | 63.68 | 64.09 | 63.27 |
| Company 10 | Great Britain | Health Care Equipment & Services | 62.93 | -3.56 | 66.49 | 64.09 | 68.88 |
| Company 11 | France | Real Estate | 59.92 | -0.42 | 60.34 | 66.48 | 54.2 |
| Company 12 | Great Britain | Health Care Equipment & Services | 62.93 | -3.56 | 66.49 | 64.09 | 68.88 |
| Company 13 | France | Health Care Equipment & Services | 64.12 | -3.56 | 67.68 | 66.48 | 68.88 |

Source: I-CV



I—CV Independent Credit View AG
*the view behind the rating*

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