Loans Paper

October 2022

TIME TO REFOCUS ON THE SYNDICATED LOAN MARKET IN EUROPE

Higher inflation, higher base rates and a repricing of the European Loan market presents a compelling opportunity for investors:

- The average yield of the European loan market is currently 10.5%[1] in Euro terms compared to a little over 4.0% just a year ago. These are levels not seen since the depths of the COVID pandemic in 2020 or the sovereign debt crisis in 2012. The attractive yield is a function of wider discount margins on European syndicated loans and higher base rate expectations
- Wider yields, particularly relative to other fixed income asset classes are largely driven by technical factors
- The current 12-month trailing default rate is running at 0.7%[2]. We expect that to rise, but not beyond a range of 3-4%. Current European loan market valuations imply default rates of well above 12%[3] annually for the next 3 years, making this an attractive entry point
- The European syndicated loan market is a defensive asset class which is well suited to the outlook of a tougher economic environment

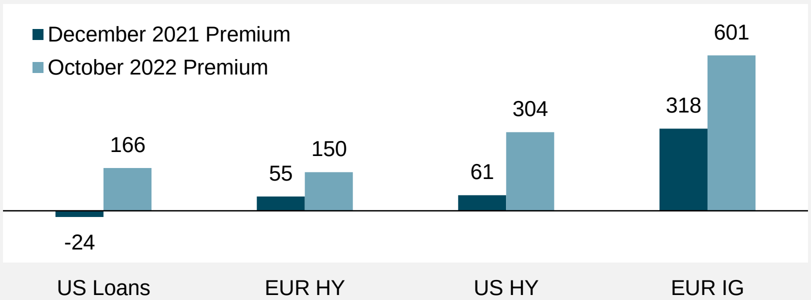
An investment in the European loan market today can deliver double digit returns, which we believe is compelling in the context of an asset class that offers very low duration, a defensive profile and stable fundamentals.

In this paper we examine each of the factors contributing to the attractive opportunity in European senior secured loans.

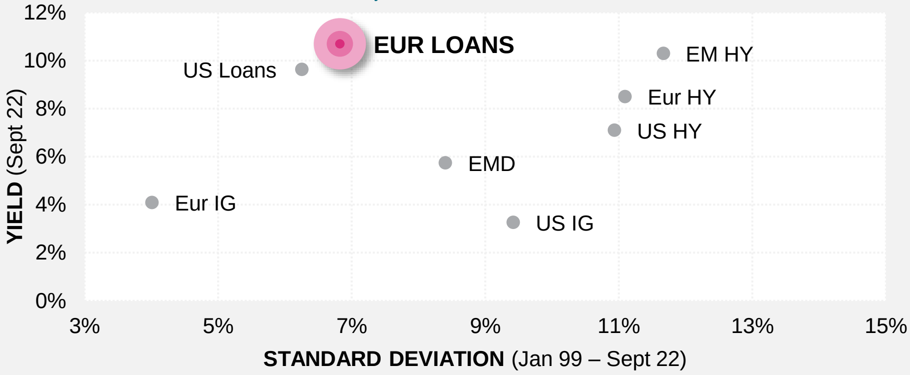
ATTRACTIVE VALUATIONS: FUTURE RETURNS ARE SUPPORTED BY ATTRACTIVE YIELDS

Over the course of 2022, average credit spreads, as measured by the 3-year Discount Margin, have risen from 415bps to 825bps[4]. At the same time markets are pricing in a significant increase in the risk-free rate, with the Euro Interbank Offered Rate (EURIBOR) expected to rise to 2.25-2.75%[5] on average over the next 3 years. Combining both results, in a yield in a range of 10.5-11%, the highest level since the depths of the COVID crisis. European loan valuations now offer outsized premiums relative to longer duration fixed income asset classes. This is largely a function of technical factors that have impacted the loan market in 2022, rather than a material relative deterioration in fundamentals. Specifically, the European loan market saw a significant pick up in new loan issuance at a time when demand slowed from lower collateralized loan obligations (CLO) issuance. The supply/demand imbalance has now abated, and the technical backdrop is more balanced going forward, underpinning the attractiveness of yields relative to other markets. The relative value of the European loan market is even more compelling considering the low long-term volatility, as illustrated in the risk/return graph on the right.

CREDIT SPREAD PREMIUM FOR EUROPEAN LOAN MARKET



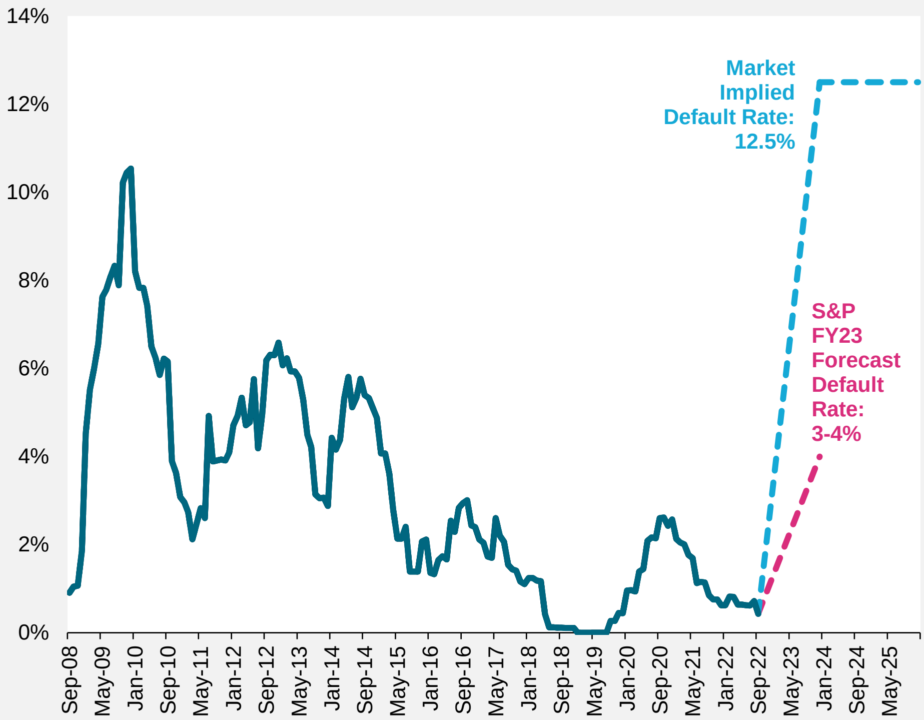
RISK/RETURN by ASSET CLASS



Past performance does not predict future returns.
Returns may increase or decrease as a result of currency fluctuations.
Alcentra, 30 September 2022. EUR Loans: Credit Suisse Western European Leveraged Loan Index (CS WELLI); US Loans: Credit Suisse Leveraged Loan Index (CS LLI); EU HY: ICE BofA European Currency High Yield Index; US HY: ICE BofA US High Yield Index; EU IG: ICE BofA Euro Corporate Index; US IG: ICE BofA US Corporate Index; EMD: ICE BofA HG EM Corporate Plus Index ; EM HY: ICE BofA HY US EM Corporate Plus Index. [1]Calculated by Alcentra based on 825bps 3yr DM plus av. Euribor of 2.25-2.75% [2]S&P Default Ratio, 31 August 2022. [3]Calculated by Alcentra based on average DM and average recovery rates for the European Loan Market (CS WELLI exc. USD). [4]CS WELLI exc. USD, October 2022. [5]Alcentra view and market view based on 3yr swap rates.

Taking European loans in isolation, we believe that the market has overtraded and that credit spreads are not reflective of the underlying credit fundamentals. As we discuss below, defaults are forecasted to increase to ~3-4% over the coming 12 months. However, at 825bps, credit spreads are implying a default rate of over 12.5% per year over the next three years, as measured by a ratio of excess spread to historical loss given default. To put that in context, even in the Global Financial Crisis (GFC), default rates only peaked at 10.5%[6] briefly. We believe that the market has overcorrected relative to underlying fundamentals and highlights the attractiveness of current valuations.

MARKET IMPLIED vs. FORECAST DEFAULT RATES



PROTECTION AGAINST RISING RATES

A key driver of broader fixed income market stress in 2022 has been, and continues to be, persistent inflation. Central banks continue to fight inflation with higher interest rates and shrinking balance sheets. As a result, risk free rates are rising. Unlike most of the traditional fixed income market, the loan market is a floating rate asset class, with coupons that typically reset on a quarterly basis in line with changes in risk free rates. As a result, the loan market tends to outperform in periods of rising interest rates. 2022 is a prime example of this. Returns for the European Loan market through the end of September have significantly outperformed other longer duration fixed coupon asset classes. For example, the European loan market outperformed each of the European HY, European IG and EMD markets by more than 9% YTD, in Euro terms.

Period		EUR Hedged Returns During Rising Rate Periods[7]							
Date	**Δ in 10-Year US Tsy Yield**	**EUR Loans**	**US Loans**	**EUR HY**	**US HY**	**EUR IG**	**US IG**	**EMD**	**EM HY**
May ‘13 – Sep ‘13	+ 137 bps	**2.54%**	0.98%	1.78%	-1.11%	-0.56%	-4.27%	-4.44%	-4.25%
Jan ‘15 – Jun ‘15	+ 84 bps	**3.39%**	2.67%	1.81%	2.30%	-1.41%	-0.43%	1.44%	6.81%
Jul ‘16 – Dec ‘16	+ 124 bps	**4.15%**	4.59%	5.35%	6.60%	0.59%	-2.40%	-1.50%	5.08%
Jan ’22 – Sep ’22	+ 202 bps	**-6.04%**	-4.51%	-15.59%	-16.07%	-15.07%	-19.80%	-17.77%	-23.43%
	Average	**1.01%**	**0.93%**	**-1.66%**	**-2.07%**	**-4.11%**	**-6.73%**	**-5.57%**	**-3.95%**

Alcentra, 30 September 2022. [6]S&P Default Ratio, 31 December 2009. [7]US Loans: Credit Suisse Leveraged Loan Index, EUR Loans: Credit Suisse Western European Leveraged Loan Index, US HY: ICE BofA US High Yield Index, EUR HY: ICE BofA Euro High Yield Index, EUR IG: ICE BofA Euro Corporate Index, US IG: ICE BofA US Corporate Index, EMD: ICE BofA High Grade Emerging Markets Corporate Plus Index, EM HY: ICE BofA High Yield US Emerging Markets Corporate Plus Index.

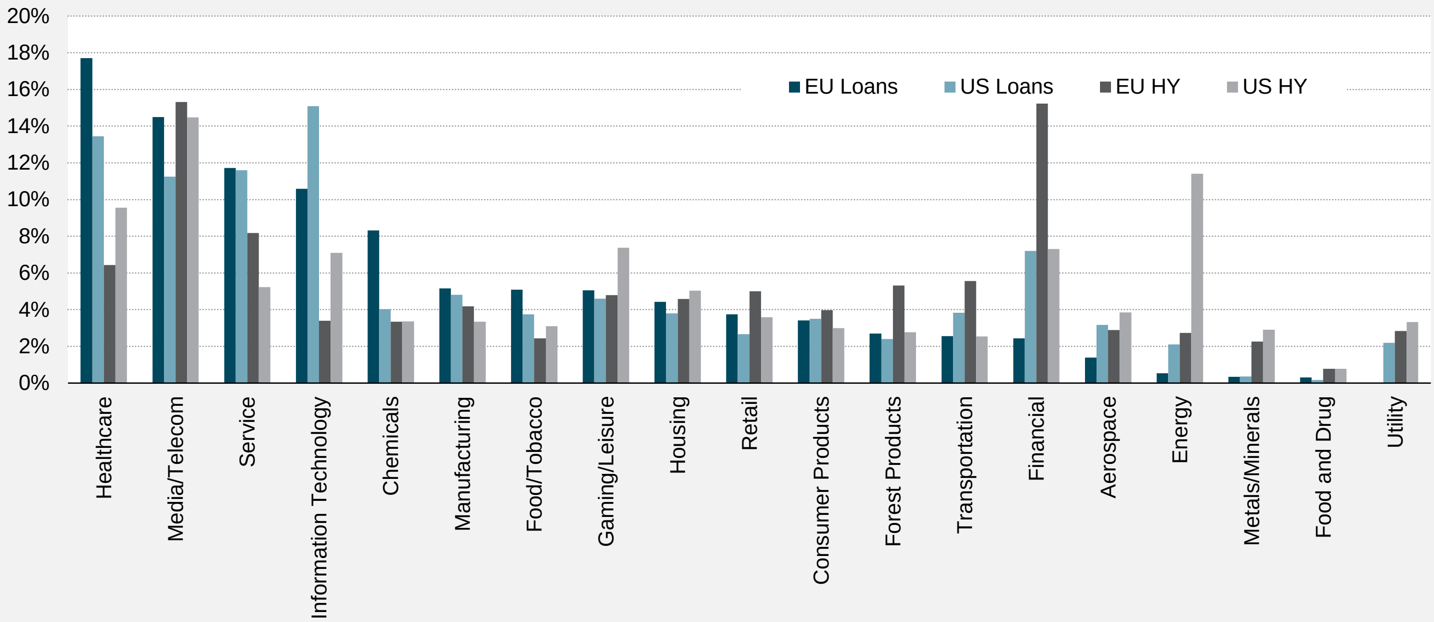
DEFENSIVE CHARACTERISTICS

Alongside protection from interest rate volatility, the European loan market also exhibits defensive characteristics that have driven stability over time. The European loan market is a senior secured asset class[8]. Senior secured loans sit at the top of a capital structure, with a first ranking claim on the assets of a company in the form of a share pledge. This is especially important in the event of defaults, resulting in historical recovery rates of 60-70%[9]. This compares favourably with other sub-IG asset classes, e.g. the High Yield market recovery rates over time have averaged at 30-40%.

The European loan market also benefits from an institutional investor base, with very limited exposure to retail investors. The asset class is well understood by market participants, which means unlike markets more exposed to those retail investors, fund flows tend to be more stable and long term in nature, contributing to lower volatility over time.

The sector profile is another driver of the stability of the European loan market, with larger concentrations in the most defensive sectors. The four largest sectors are Healthcare, Telecommunications & Media, Services (predominantly Business Services, e.g. Education, Equipment Rental) and Information Technology (predominantly Software businesses) and make up ~55% of the market[8]. Unlike other fixed income markets, European loans has limited exposure to sectors that have contributed to volatility in markets over the last 15 years[8], e.g. European High Yield has a large concentration in Southern European subordinated financial debt or Energy, which is more concentrated in US markets. We believe the defensive sector concentrations position the market well against prominent risks such as input costs and weaker consumer demand.

SECTOR EXPOSURE[10]



STABLE CREDIT FUNDAMENTALS

Looking ahead, we are comfortable with the fundamental credit health of European loan issuers. Leverage for European loan market issuers remains stable, with averages below levels prior to the GFC. In addition, interest coverage ratios, the extent to which earnings cover an issuer's interest burden, are high, and again in much better shape compared to before the GFC. This gives European issuers significant cushion to withstand higher risk free rates going forward. At Alcentra, we are very focused on this point. We continuously monitor our portfolio companies to ensure capital structures are sustainable. Our financial models automatically consider live yield curve expectations over the life of the loan and we favour issuers with larger cushions. As a result, the interest coverage ratio for our strategy exceeds that of the underlying market.

An additional important point of comfort is the current level of contributed equity across the market. This measures the cash equity provided by private equity sponsors to companies at issuance. The greater the level of contributed equity, the greater the cushion that needs to be eroded before a senior secured loan becomes impaired. Prior to the GFC, the average level of contributed equity stood at 25-30% compared to current levels at 45-50%[9]. During COVID, we saw the importance of this in action, as private equity sponsors were more willing to contribute fresh capital to companies that saw liquidity diminish as global economies ground to a halt. As a result, default rates during that period were much lower than initial ratings agency expectations[11]. We expect similar behaviour going forward.

Past performance does not predict future returns.
Returns may increase or decrease as a result of currency fluctuations.
[8]CS WELLI exc. USD, October 2022. [9]Credit Suisse Default Report. [10]Alcentra, 30 September 2022. Credit Suisse Western European Leveraged Loan Index; EU Loans, Credit Suisse Leveraged Loan Index; US Loans, Credit Suisse Western European High Yield Index; EU HY, Credit Suisse High Yield Index; US HY. [11]S&P Default Ratio.

CONCLUSION

In summary, European syndicated loans are offering higher returns than at any time since the depths of the COVID crisis.

While expectations of higher base rates and wider credit spreads reflecting a more inflationary environment have contributed to the higher yields, technical factors in the loan market have driven those yields to levels greater than required to compensate investors for the increased risk. Current loan pricing is implying corporate default rates in excess of 12.5%[12] whereas rating agencies predict defaults will rise to no more than 3% to 4% over the next 12 months. European loans are cheap.

Syndicated loans are a floating rate asset class, so are ideally suited to a rising rate environment since their return increases as base rates rise. European loans outperform in rising rate environments, highlighting the need for European loan funds to minimise out-of-market allocations to assets such as fixed rate bonds.

This is a defensive asset class which protects investors from the impact of defaults as it benefits from a senior secured claim on the underlying borrower. The sector profile of the European loan market is skewed toward defensive industry sectors like healthcare, telecommunications and media and business services. These characteristics have helped the market exhibit low volatility relative to other fixed income asset classes.

European loan issuers as a sector are well prepared for tougher markets, exhibiting stable leverage, healthy interest coverage ratios and high levels of contributed equity.

In our opinion, these factors offer a compelling reason to invest in the European loan market as a way to deliver attractive returns combined with a reasonable expectation of low volatility.

[12] Calculated by Alcentra based on average DM and average recovery rates for the European Loan Market (CS WELLI exc. USD).

Disclosures

This is a financial promotion and is not intended as investment advice. The information provided within is for use by professional investors and/or distributors and should not be relied upon by retail investors.

The information included herein has been provided at your request in connection with your consideration of whether to invest in the Strategy. It should not be construed as investment advice or serve as a primary basis for investment decisions to invest assets in the Strategy. Prospective investors should consult a legal, tax or financial professional in order to determine whether any investment product, strategy or service is appropriate for their particular circumstances.

Franklin Templeton holds the majority of The Alcentra Group (or "Alcentra"), which is comprised of the following affiliated companies: Alcentra Ltd. and Alcentra NY, LLC. Assets under management include assets managed by both companies. Alcentra NY, LLC is registered with the U.S. Securities & Exchange Commission under the Investment Advisers Act of 1940. Alcentra Ltd. is registered with the U.S. Securities & Exchange Commission under the Investment Advisers Act of 1940 with respect to its US clients.

Alcentra Ltd is authorized and regulated by the Financial Conduct Authority – Registration number 196845 - and regulated by the Securities Exchange Commission with respect to its US clients – Registration number 801-74223. Registered office for Alcentra Ltd is160 Queen Victoria Street, London, EC4V 4LA, UK. Alcentra NY, LLC is regulated by the Securities Exchange Commission – Registration number 801-62417. Registered office for Alcentra NY, LLC is 9 West 57th Street, Suite 4920, New York, NY 10019.

Unless you are notified to the contrary, the services mentioned are not insured by the FDIC (or by any governmental entity).

Key Risks

Past performance does not predict future returns

The value of investments and the income from them is not guaranteed and can fall as well as rise due to market and currency movements.

An investor should consider the Fund's investment objectives, risks, charges and expenses carefully before investing. Portfolios are subject to investment risks, including possible loss of the principal amount invested. Material in this publication is for general information only and is not intended to provide specific investment advice or recommendations for any purchase or sale of any specific security or commodity. No specific investment objectives, financial situation or particular needs of any recipient have been taken into consideration in connection with the preparation of this presentation. An investment in the Fund does not constitute a complete investment program.

Investments in sub-investment grade debt are speculative and involve special risks, and there can be no assurance that an account's investment objectives will be realized or that appropriate investments may be identified. Many factors affect performance including changes in market conditions and interest rates and in response to other economic, political, or financial developments. An investor could lose all or a substantial portion of his or her investment. No investment process is free of risk and there is no guarantee that the investment process described herein will be profitable. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.