Asset-backed lending in turbulent times

While the pandemic has caused major disruption to our everyday lives, the direct and indirect effects of government intervention, monetary policy, the war in Ukraine and Brexit are also taking shape. With global supply chains impacted, soaring inflation and product shortages, the current environment is clearly challenging. However, with dislocation comes opportunity.

Many investors and managers have historically focused on corporate private credit, directly lending to companies based on their cash flows. RoundShield's senior investment team, on the other hand, has specialised in providing loans secured by assets for the last 20 years. While focused on generating strong risk-adjusted returns, RoundShield first and foremost seeks to protect investor capital. The focus is on managing downside risk by considering liquidation values of underlying assets (infrastructure, real estate and other hard or financial assets) vs. EV or EBITDA in our underwriting. RoundShield also places significant emphasis on investing in markets and through structures which enable efficient enforcement if necessary. Many assets also benefit from long term contractual cash flow streams, mitigating risk in more volatile periods.

RoundShield believes that investing in asset-based strategies throughout cycles, and lending against hard assets instead of just company cash flows, provides the lender with a more precise underwriting ability and a clearer path to capital recovery in downside scenarios. As inflation reaches a 40 year high, interest rates continue to rise and insolvencies emerge, it is no surprise that investors are starting to show more interest in asset-backed strategies.

Deal sourcing in a fragmented Europe

RoundShield's search for deals is extensive and far reaching. We work with approximately 2,000 deal intermediaries, reviewing over 1,500 deals a year, investing only in five to ten. Our deal sourcing model, developed over the last 20 years, gives us access to off-market deal flow and is a crucial competitive edge in the fragmented and inefficient European SME financing market.

Understanding the unique intricacies of each country across the region requires experience and local knowledge. Currently our focus remains on Western Europe, and our ability to shift between markets as jurisdictions become more or less attractive keeps us competitive. RoundShield's network of offices in Jersey, London, Geneva, Luxembourg, Madrid and Paris, with staff speaking 17 languages gives us a deep understanding of how each market works as well as their cultural nuances. We only invest in markets where we have deep sourcing relationships, in-house local expertise and a strong knowledge of the legal framework.

Joint ventures also provide deal-flow and over the last few years we have formalised a number of distressed-focused JVs across our target regions and asset classes in anticipation of, what we believe will be, a substantial distressed environment over the next 12-36 months.

Adapting to a new inflationary environment

Across our funds we have had exposure to residential homebuilding, student housing, social and affordable housing, solar farms and other more traditional asset classes. We have also invested in more operationally focussed assets such as nursing homes, hotels, self-storage facilities, pubs, restaurants, and nursery schools as well as more esoteric real estate such as cemeteries and golf courses.

Looking briefly at the construction industry in today's environment, RoundShield is more focused on downside protection than ever. Cost inflation is being driven by staffing shortages, pressures in the logistics market and rising energy prices. While some manufacturers have managed to pass these costs to developers and contractors, others have had to file for bankruptcy, further squeezing supply and driving prices up. Dynamic funding models are needed to protect investments from future price movements during the construction phase.

Robust due diligence is key. Construction costs have to contain sufficient contingency to withstand further inflation, as well as materials and labour shortage-driven delays. Due diligence extends to staffing, including a detailed review of the full professional team, main contractor, and subcontractors, as well as a review of the developer's internal team to control overheads.

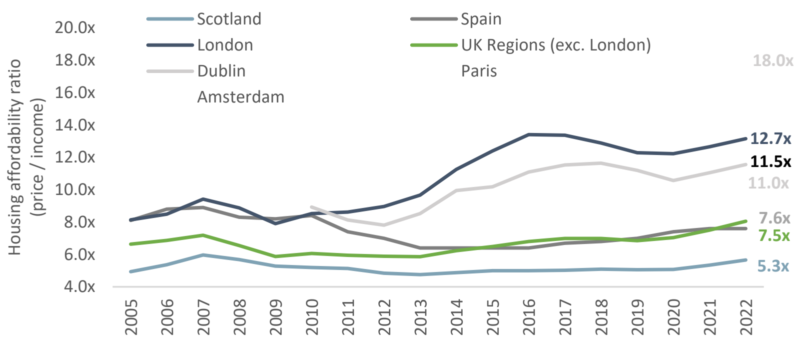
The pressures across the construction industry have also led RoundShield to increase protection against the inherent risks of development within the funds. Steps taken include working only with deeply experienced developers and well capitalised contractors, additional asset surveillance, enhanced monthly monitoring reporting, fixed priced contracts and additional construction-focused resources in-house.

Outlook

We currently view the opportunity set for our strategy as attractive over the foreseeable future. Insolvencies previously masked or delayed by government support continue to emerge and pockets of distress are becoming more apparent.

Volatility and market uncertainty have led to significant bank retrenchment and many otherwise healthy companies that have taken on too much government debt through the pandemic are now looking for capital, such as that provided by RoundShield, to consolidate liabilities. As balance sheet debt levels increase and maturity walls peak, we increasingly see an opportunity to acquire assets out of bankruptcy and to provide white knight financing capital.

Bankruptcies caused by over-levered capital structures are on the rise and increasingly we also see distressed development projects where costs have escalated to the extent there is no liquidity left to cover cost overruns. RoundShield's entry basis on these assets is typically at levels significantly below replacement cost, allowing us to make lucrative returns. As an example, we recently acquired a stalled in-administration student housing project in the Northwest of England which was halfway complete at acquisition. With pandemic-related delays and subsequent construction cost inflation, the incumbent developer defaulted on its construction loan and had insufficient equity to restructure and complete the project. RoundShield stepped-in with a bespoke debt and equity facility to a new development team, with a proven track-record in complex student housing projects, to acquire and fully-fund the completion of the de-risked project.



Source: Land Registry, ONS, CSO, CIA

Outside of the more distressed examples, RoundShield focuses on high barrier to entry asset classes or those where we have long term lease income with inflation protection. For instance, we are currently financing a company that acquires freeholds from operators of residential homes for children in England. The underlying income is government-backed and the real estate is only acquired with the benefit of 21-year fully inflation-linked leases. Likewise, we have deployed over €200 million of capital over the last three years in Irish social housing assets which are leased to Irish government entities for 25-years, also with the benefit of inflation indexation.

Thematically we still see significant opportunities in asset classes such as social and affordable housing. There remains a structural supply demand imbalance in most of our jurisdictions and we do not believe that the supply deficit can be resolved in the near term. We also like similar social infrastructure asset classes with attractive supply demand fundamentals and the ability to acquire or create long term contractual cash flows with inflation linkage.

In economic times like these, a safety-first mentality is all the more important and given our experience navigating complexity across multiple jurisdictions, coupled with our extensive sourcing capabilities, we believe that we are well positioned to manage the uncertain times that we will likely continue to experience over the coming years.

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