

# Investor Letter



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Chief Executive

In this letter we will be dealing with three topics, firstly our views on the Eurozone crisis and its impact on our general macroeconomic outlook for 2012 and our strategy for the portfolio, secondly our outlook for the European leveraged loan market in 2012 and finally, our forecast for defaults over the coming year.

## 1. Eurozone crisis, macro-economic outlook and portfolio strategy

The Eurozone crisis is at its essence political and will ultimately be resolved (or not) by the politicians. We (or anybody else for that matter) cannot bring any special insight into what is currently going on in the minds of those same politicians or how they will react as the crisis develops further during 2012.

Given the above we will only make a couple of relatively brief points on this topic:

- As outlined previously, we do not expect financial Armageddon (i.e. a disorderly sovereign or bank default or a disorderly break-up of the Eurozone) to happen in the short term (i.e. over the next 6-12 months). However, this risk is clearly a non-zero possibility and if it does happen, the consequences for the global economy will be disastrous for numerous reasons that have been well articulated elsewhere. Our highly subjective assessment of this risk is 5-10% over the next 12 months driven mainly by policy error or the risk of events spinning out of the control of policymakers unexpectedly.
- The current Eurozone policies, if they continue to be followed (without additional growth promoting measures), will **almost certainly** lead to a partial or full break-up of the Eurozone in the medium term (i.e. over an 18 month to 3 year period). This is because at its heart, the Eurozone crisis is as much about competitiveness and growth as it is about sovereign debt levels, liquidity or bank solvency. In the medium term, peripheral countries need reform, financial assistance and above all growth if they are to survive being tied to the incredibly competitive European core economies.

- To date, all we have seen from the “core” country policymakers is a requirement for fiscal probity, a necessary but by no means sufficient solution to the Eurozone’s crisis. Ireland for example, is three years into its austerity programme and is being portrayed in some quarters as a poster boy for the austerity/internal devaluation approach. To date the Irish have had a 22% peak to trough reduction in nominal GDP (13% real) and by most estimates, despite the pain taken to date, still have another 10-20% reduction in unit labour costs to go before we become fully competitive again with Germany. It is extremely unlikely in our view that anything like this level of austerity/internal devaluation can be successfully exported to Italy, Spain, Portugal or Greece (never mind France) without blowing up the political and financial systems and creating massive social unrest in those countries.
- The current policy mix of fiscal austerity and bank deleveraging is almost certain to lead to a decline in Eurozone GDP next year. This is as much a mathematical equation as it is a forecast. With most of Europe reducing their fiscal deficits in 2012 by 2-3% of GDP, the only way mathematically in which GDP can grow is if consumption, investment or net exports more than offset the slack next year. For various reasons, we think this is highly unlikely to happen and we forecast a deep (although possibly uneven across countries) recession in Europe overall this year.

While we believe that the absolute worst case for the European and global economy will be avoided in 2012, our views on the macro environment overall in 2012 are negative as articulated above.

Factors which we do not necessarily expect to happen but that might cause us to revise our negative outlook for the European economy in 2012 would include in no particular order:

- Stronger than expected global growth
- Extensive QE from the ECB - the recent €500bn 3 year TRO is a good start but it, in effect, only offsets the reduction in liquidity to the European banking system caused by a reduction in wholesale and money market funding
- Some evidence of the effective socialisation of Eurozone financial and sovereign risks (e.g. the issuance of Eurobonds); or
- A TARP style forced recapitalisation of the European banking system.

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On the global growth question which is arguably the most likely of the above factors to come to Europe's rescue (particularly if the Euro FX rate were to decline significantly), the key economies to focus on as well as the Eurozone are the US and China (the three of which collectively make up nearly 70% of the global economy).

On the US economy, we have no special insight other than to observe that our small number of US domiciled or oriented businesses are performing very well (EBITDA +10% on prior year). In addition, the US is now entering Year 6 of its housing market deflation and it is clear that on many measures (rental yields, rental growth and new household formation) the US residential housing market is much closer to its trough than peak. If this market were to stabilise and show tentative signs of growth in 2012, the implications for US consumer and financial balance sheets, investment and consumer and business confidence would be huge and a big boost to the US and global economies. Whether this uplift occurs in 2012 or not we do not know, but basic laws of supply and demand would suggest that at some point over the next 12-24 months, we will see much awaited 'green shoots' here.

On China, we have as our investors know, had some concerns regarding the short to medium term economic outlook for some time now. China is now roughly 10% of the world economy and growing at approximately 8-10% per annum. As such, it alone will account for a quarter to a third of expected global growth of 3-4% next year (in reality its impact on global growth is much higher if its impact on economies in Australia, Asia and Latin America is taken into account). While the direct impact of China on Avoca portfolio companies is negligible (in a recent review carried out by us <2% of Avoca portfolio company sales are directly to China), its growth prospects have important implications for the global economy.

Our concerns with China mainly centre around the fact that Investment now makes up close to an incredible 50% of the Chinese economy. This figure is unprecedented in the recent history of economic development. Again a mathematical observation rather than a forecast is that if Investment were simply to stop growing, the remainder of the Chinese economy (comprising domestic consumption, government spending and net exports) would have to grow in double digits to ensure the economy stays growing at 5-10% per annum in 2012 and beyond.

This level of growth in the non Investment part of the Chinese economy clearly could happen, but if it does not, the prospects for 8-10% economic growth in China over the next few years look weak with knock-on implications for global growth. Avoca will be visiting China in March of this year to get an "on the ground" feel for these issues. We will report back our findings to investors in our next letter.

Our strategy for the management of the portfolio in the coming year will be to:

- Continue to focus on senior secured debt in "core" European countries - senior debt currently represents 95% of the current portfolio and offers excellent relative and absolute value;
- Reduce exposure where possible to remaining subordinated debt positions (down from 12% of the portfolio to c.5% through a combination of sale and natural run-off over the last 18 months);
- Continue to look to reduce exposure to the UK consumer where possible - we are particularly negative about the UK economy due to a combination of over indebtedness at the household level, a weak banking system, government austerity measures and persistent imported inflation;
- Avoid peripheral European exposure unless we are offered outstanding value to take such investment risks; peripheral country exposure currently amounts to 9.6% of the Avoca portfolio of which we estimate that less than 5% is direct exposure to the peripheral economies themselves.

### 2. Outlook for European leveraged loan market in 2012 2013-2015 refinancing wall

One of the key issues facing the European loan market over the next couple of years is the means of dealing with the wall of refinancing of the 2006/07 vintage loans that will come due for repayment over the period 2013-2015.

Approximately €65bn of 2006/07 vintage European leveraged loans will come due for repayment in 2013-15. This is in an environment where existing CLO's are coming to the end of their re-investment periods, banks are increasingly constrained in their ability to lend and there has been no appreciable new CLO issuance for 3 years and no prospect of the same in the short term.

The first point to make is that there has already been substantial shrinkage of the refinancing wall over the past 3 years through a combination of Amend and Extend ("A&E") requests, M&A activity, refinancing through the Bond market and also the fact that the 2006/07 vintage has already come through a default cycle over the past 3 years. We estimate that approximately 45% of the overall 2013-2015 refinancing wall has already been removed over the past 3 years using the following methods:

| Driver                | % of amortization reduction |
|-----------------------|-----------------------------|
| Full Refinancing      | 49%                         |
| High Yield Takeout    | 15%                         |
| Amend and Extend      | 31%                         |
| Default/Restructuring | 5%                          |
| <b>Total</b>          | <b>100%</b>                 |

Source: Avoca estimates, S&P LCD

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Despite the above progress, to date Europe has been behind the US in dealing with the 2013-2015 refinancing issue. As well as the fact that the US is a much more liquid Loan market and has a larger and deeper Bond market, another factor in Europe has been that over 90% of the outstanding leveraged loans are to private equity owned borrowers (versus approximately 50% in the US). Private Equity owners in Europe were reluctant in 2009 and 2010 to use A&E to push out their refinancing requirements as they had locked in cheap financing. Given an improving macro environment and their 5-7 year ownership horizons, they believed that they would exit the portfolio companies before the amortisation of the loans in 2013-2015 became an issue.

Given the current macroeconomic environment and the reduced likelihood of near term exits, we believe that there will be significant private equity driven A&E activity in Europe this year. This is borne out by recent discussions with investment banks who are expecting a "deluge" of A&E requests across the European market in 2012. This will be very positive for existing spreads on European leveraged loans and we expect to see the weighted cash spread for the market increase by 75-80bps (i.e. go from approximately E+320bps currently to at least E+400bps) by the end of the year.

We have written extensively about the refinancing wall in Europe in the past (See our "One Bite at a Time" research paper which is available to download from our website [www.avocacapital.com](http://www.avocacapital.com)). In Q1, we also plan to issue an additional short updated research paper on this issue and its potential short and medium term impact on our market.

### Default and restructuring outlook

Notwithstanding a likely negative macroeconomic environment, we expect default rates for European leveraged loans to remain low (3-4%) in 2012. The key driver of this low default rate is extremely low interest rates, good liquidity profiles and minimal debt amortisation requirements across the market in 2012.

We expect that the default cycle will pick up again in 2013-2015 in part driven by the refinancing requirement described above. Given the highly uncertain macroeconomic environment, it is too early to be definitive on this point, however our current expectation is that this default cycle will be of the order of 15-20% (cumulative) over those three years.

The driver of that forecast relates to the fact that in our estimate, approximately 20-25% of the overall European leveraged loan market currently remains greater than 5x leveraged on a total debt/EBITDA basis and is as such at risk of not being in a position to refinance itself when current loans become due.

Having survived the 2008-2010 crisis, most of these companies are large, stable and generally good quality businesses. Their issue is not business quality but excessive leverage. While they can pay their interest bill today given low interest rates, they

have minimal ability to deleverage meaningfully to the 5x EBITDA or less that the market will tolerate as a refinancing multiple today. The key risk of loss for these businesses will be in the subordinated debt as we would expect senior debt losses to be minimal given the size and quality of the businesses.

On restructurings, we expect there to be significant activity in the year ahead driven by financial covenant breaches as many covenants will ratchet tighter in 2012. We expect that unlike 2008-2010 the lending community in Europe will be much less interested in offering borrowers cheap or temporary covenant/waiver solutions. Again for senior secured lenders, this will be an opportunity to increase our economics on the loans.

### New Issuance

Total Primary issuance of senior secured leveraged loans in Europe in 2011 totalled a respectable c.€44bn (roughly two-thirds the average annual issuance rate since 1999 of €65bn). However, this was a tale of two halves with issuance in the first seven months of 2011 amounting to €34bn and a mere €10bn in the five months from August to December.

We expect issuance this year to be subdued, but not quite as bad as the run rate in H2 2011 would suggest. We are aware from our discussions with the investment banks that the pipeline for H1 is reasonable driven mainly by global private equity houses having substantial dry powder available and actively looking at current opportunities. However, bank underwriting appetite is limited and the expectation currently is that there is only approximately €500-600m of syndication capacity per deal in the European loan market. We expect to see some ostensibly European based deals financed predominantly with dollars in 2012 given greater liquidity in that market.

The good news is that given the mismatch between supply and demand of capital, new deals that are being issued in Europe will be attractive with senior debt/EBITDA levels at 3.0-4.0x and coming with margins of at least L+500bps.

### Secondary market conditions

The S&P ELLI index is currently priced at 84 which implies an effective yield of approximately E+630bps. This represents a decline from a price of 88 (approximate yield of E+475) in January 2011. Overall, the total return for the asset class for the year was +0.7%, with the above price decline being roughly offset by the cash margin earned on the loans. By way of comparison the total return on the European HY market in 2011 was -1.0%.

The current yield on the European leveraged loan market and the price weakness for the asset class during 2011 is not really in our view indicative of inherent credit risk. As noted above, we expect defaults for 2012 to be of the order of 3-4% and with a historic recovery rate for senior secured loans of 80%, we expect credit losses on the asset class in 2012 to be no more

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than 50-100bps, much less than the E+630bps gross yield currently on offer.

It is very difficult to find a meaningful supply of loan assets at the mid prices currently quoted by the market makers with effectively a wide bid offer spread between buyers and sellers. We have not seen any signs of material selling of leveraged loans by European banks despite their well publicised desire to deleverage nor do we expect to see any such signs given the current effective yield on the asset class and the impact of the recent 3 year LTRO.

On the demand side we expect to see an increasingly material bid over the course of 2012 from newly launched institutional loan vehicles. Overall, given current supply and demand dynamics and other factors such as the impact of A&E as described above, our base case, notwithstanding a negative macro environment, is that secondary loan prices will rise in Europe across the market in 2012.

### 3. Outlook for Avoca Portfolio Defaults

It is customary in Avoca at the start of each year to forecast the likely level of defaults across our portfolio over the coming year. Before reading this section, readers might want to review the table below which shows the accuracy of the forecasts in this section over the past 2 years.

| Year     | 2010     |        | 2011     |        |
|----------|----------|--------|----------|--------|
|          | Forecast | Actual | Forecast | Actual |
| Defaults | 4-5%     | 2.5%   | 2-3%     | 0.2%   |

Overall, we have been reasonably accurate if a little cautious in our forecasts over the past 2 years.

Bearing that in mind, our forecasts for the key metrics in 2012 are as follows:

| Driver            | 2012 |
|-------------------|------|
| Defaults - Market | 3-4% |
| Defaults - Avoca  | 2-3% |

As noted above, we are forecasting a relatively low level of defaults for the European loan market in 2012. We expect Avoca to outperform the market, with the majority of our defaults coming from legacy classified directory positions (i.e. yellow pages). This is an issue primarily for our CLO funds as our total return funds do not contain any meaningful exposure to this sector.

### Other matters

#### *New fund launch - Avoca Senior Loans Europe*

Having successfully launched our Qualifying Investor Fund for leveraged loans in Q4 with €50m of new investor seed capital, Avoca will also launch a London listed vehicle for leveraged loans in Q1 of this year. This fund will take an unleveraged exposure to the European leveraged loan asset class and is targeting net returns of E+500bps with a minimum dividend yield of c.5%.

We expect that there will be a growing number of such vehicles launched in 2012 driven by investors being attracted to high cash spreads and running yields offered by the asset class as well as the capital protection offered by its first lien status. Our target initial launch is €50-€100m.

Investors interested in finding out more about this fund, or any of our fund products, should contact either our Head of Investor Relations, Kevin McMahon ([kevinmcmahon@avocacapital.ie](mailto:kevinmcmahon@avocacapital.ie) or +35314793116) or our Director of Marketing, Robert Burns ([robertburns@avocacapital.com](mailto:robertburns@avocacapital.com) or +44 7515 756 425).

#### *Hedge Fund team*

Our Hedge Fund team led by Simon Thorp have just completed another excellent year in what were very difficult market conditions. They ended 2011 with a c. 1% positive return net of fees which is very good in itself in a tough year but given that it is their 10th straight year with a positive return, it represents a phenomenal track record (annual returns since inception in 2001 have averaged 9% per annum).

Simon's team has increased from 5 personnel to 11 since joining Avoca and we have also invested significantly in improving their technology platform over the past 6 months. Having successfully integrated the team, we will commence marketing the fund to new investors in 2012. Our latest recruit to the team is Rachel Black who joined us in January and will be responsible for marketing the team and their funds.

Finally, embedded in their track record, Simon and the team have a very successful 10 year track record investing in European High Yield and we expect to launch a long only High Yield product managed by the team in 2012. As our investors are aware, we have resisted the temptation to start investing in European High Yield over the past 18 months due to concerns that absolute yields on the asset class at 6-7% were too low. With yields on a carefully selected European HY portfolio now in double digits, we believe the time to launch a product in the asset class has now come. We will keep investors informed of our launch plans for this fund during the course of the year.

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### *Convertible Bond team*

On December 12, Avoca also announced the hiring of a Convertible Bond team. The team, led by Tarek Saber, comprises 5 individuals, most of whom worked together previously at the €280bn Dutch pension fund, APG, where they were responsible for managing €6bn in long only Convertible Bond assets, one of the largest portfolios globally in the asset class

Tarek and the team had a tremendous track record at APG, substantially outperforming the UBS Convertible Bond index over the 7 years they managed the portfolio. Avoca will also be joined in the venture on a non-Executive basis by Darren Carter, the former head of KBC Financial Products, who has over 25 years experience investing in and managing teams in the Convertible Bond Asset class.

The Convertible Bond asset class is an extremely interesting product, offering downside protection through the bond portion of the investment as well as significant equity upside from the equity conversion rights. We believe that there will be increasing investor focus on the asset class in 2012 and coming years as investors seek to increase the potential return profile from their existing fixed income and sovereign bond portfolios in what is likely to remain (in the short run at least) a low interest rate world.

Tarek and the team will initially focus on running a "best ideas" long only fund with \$25m seed capital provided by Avoca and partners. The team, with assistance from Avoca credit analysts, are currently working on due diligencing the prospective portfolio and we expect to be in a position to approach prospective investors with a fund launch sometime later in Q1.

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