

Quarterly Investor Letter

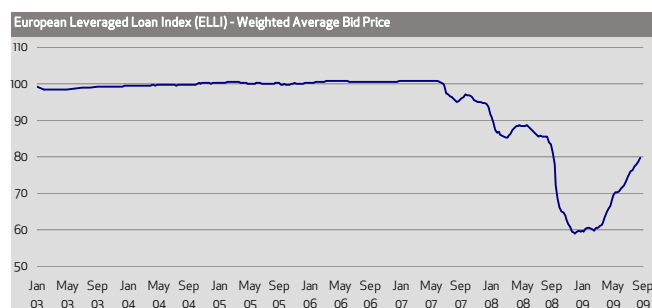
"Are We There Yet?"



Alan Burke,
Chief Executive

The question "Are we there yet?" has been heard by every parent who has ever bundled the children into the back of the car for that three hour drive to the holiday home on the coast. The answer from my parents, at least to this question, was always "nearly" or "not far now". This usually sufficed until the next round of questions came at ever shortening durations until we eventually reached our destination, happy to escape our back seat shackles and eager to get on with the important childhood business of summer play.

This regression to childhood memories has been recently brought to mind by its similarity in tone to a question I have been asked by a number of investors over the past month or so namely "Is the leveraged loan market at fair value yet?" Investors' desire is to know whether this journey we are on in the European leveraged loan market (from insanely cheap back to fair value) is one that is nearly over now or like the car journeys of our youth has a bit to go yet.



Source: S&P LCD

On the face of it, this is a reasonable question for investors to ask as our market is up approximately 40% since its trough (the ELLI index has moved from 59 at trough in January to 80 currently). At the same time, the credit cycle is clearly still playing itself out as defaults continue to rise in what is still a tough macro environment for highly leveraged companies.

There are only really three questions that need to be asked and answered in assessing where our market is on its journey back to fair value. These are:

- What is fair value for investing in the asset class of European leveraged loans;
- What is the gross return (i.e. pre-credit losses return) implied by the current market price; and
- What are the cumulative credit losses likely to be on the asset class through this cycle?

Question 1: What is a fair expected return for the leveraged loan asset class?

There are ultimately only three broad asset classes an investor can choose to invest in- cash or cash equivalents, debt (government or corporate) and equity risk assets. This categorisation may seem to ignore some large investment categories that have found their way into "alternative investment" buckets over the past decade or so - e.g. private equity, hedge funds, commodities, real estate, agricultural land, timber etc.

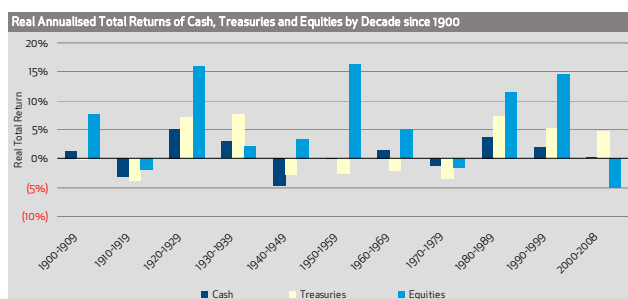
However, all of these latter categories can arguably be bunched into one of the big three. An investment strategy may involve the use of leverage (e.g. private equity), sophisticated use of options, risk management and hedging techniques (e.g. CTA's, hedge fund managers) but at the end of the day when investing, you are either investing in cash, lending capital to somebody else for an expected return or investing it in a first loss equity position.

The returns for lending cash to somebody should broadly over time track inflation with a little something extra for the additional risk taken. However, cash investors have historically actually received slightly lower returns than inflation probably reflecting inherent risk averse human nature and the occasional tendency of governments as debtors who control money supply to cause unexpected inflation.

“Are We There Yet?”

The returns for lending money to somebody should in theory be higher than investing cash - you are after all taking credit, duration and other risks in doing so. Historically, returns on “safe” government debt (e.g. US treasuries) have been in the order of inflation plus 0.5% or so, while the returns on high grade corporate debt have tended to be slightly higher in the range inflation plus 1.0-1.5%.

The returns for taking equity risk should in theory in the long run be broadly in line with growth in long term nominal GDP (historically of the order of inflation plus 5-6%). There clearly are some talented entrepreneurs, private equity managers, hedge fund managers or CTA’s out there who can (without leverage) do better than this (at least for a period) by utilising superior operational management, sophisticated hedging or risk management techniques (the “talented manager” syndrome). And if an investor is lucky enough or smart enough to get the investment decision timing consistently right you can benefit from the booms and panics that periodically cause risky assets to undershoot fair value and earn substantially better long term returns (the “talented investor” syndrome). However, at a macro level the immutable laws of nature kick in and bring equity returns back to growth broadly in line with the real economy.



Source: Deutsche Bank – “100 Years of Corporate Bond Returns Revisited”, November 2008

Where do leveraged loans sit in this continuum of investment opportunities? Logically they should sit below equity risk but at the higher end of debt investing risk. An investor watching the impressive price gyrations of European leveraged loans over the past two years might be forgiven for thinking that these instruments carry equity like risk, but well underwritten senior secured loans should typically attach at approximately 50% of recently traded Enterprise Value (as evidenced by a recent private equity transaction) and in the range 50-100% of long term Enterprise Value on average. Therefore, logically they should carry lower risks and earn corresponding lower returns than equity. If high grade corporate debt earns inflation plus 100bps or so and equity earns inflation plus 500bps then it

seems logical to suggest that inflation plus 200-250bps or so might be a fair value expected return for investing in the leveraged loan asset class.

The leveraged loan asset class is a Euribor based product. On the basis that Euribor should in the long run be a proxy for inflation (probably fair in the long run in a Bundesbank dominated eurozone), that would suggest a fair value return on the European leveraged loan asset class should be in the range Euribor + 200-250bps.

Question 2: What is the European leveraged loan market currently delivering in terms of gross returns before losses are taken into account?

The European leveraged loan market as measured (imperfectly) by the ELLI index is currently priced at 80 cents in the Euro. If we take a conservative assumption that the likely duration of these loans is 5 years (despite the fact that they are typically callable at any time at no penalty to the issuer) and the original spread on the loan was E+275 bps, the DM on the market is currently 850bps (which corresponds to Euribor plus 750bps).

Here in Avoca we have completed detailed research into the historic duration of the European leveraged loan asset class. Since 2003, it has averaged 3.4 years duration to repayment (i.e. on average each loan was outstanding for a period of 3.4 years before the borrower elected to prepay or refinance the loan). A previous study carried out by us in 2000 showed an average duration of approximately 3.2 years for European leveraged loans over the period 1990-2000.

While prepayment rates in the market are currently very low and, correspondingly, current duration of loans is higher than historic levels, our micro level research and discussions with private equity owners suggest that prepayments are likely to materially increase over the coming years as private equity owners seek to monetize the portion of their 2006/07 vintage investments that are performing well through IPOs or trade sales. We have already seen evidence of this trend with the recent €2.6bn sale of Orangina (formerly the Cadbury Schweppes beverage unit) by Blackstone to Suntory of Japan. We estimate at least 20-30% of current Avoca portfolio companies are realistic IPO/trade sale candidates over the next 12-18 months.

Talking all of this into account, we are comfortable that our duration estimate of 5 years used in estimating the gross yield for the market is likely to prove conservative.

¹ Cash relates to US 3-month T-Bill yield. Treasuries relates to US 30yr Treasury yield. Equities is S&P 500 post-1926 and equity data from “Irrational Exuberance” by Robert Shiller pre-1926

“Are We There Yet?”

Question 3: What are the losses on European leveraged loans likely to be through the cycle?

Question 1: ‘What is a fair expected return for the leveraged loan asset class?’ was answered by looking at our asset class in terms of its inherent risk and its required returns when compared with those required of other risky asset classes.

Question 2: ‘What is the European leveraged loan market currently pricing in gross returns before losses are taken into account?’ was answered using the current market price and some basic assumptions on duration and yield.

Question 3 ‘What are the losses on European leveraged loans likely to be through the cycle?’ is the hardest question of the three as it concerns the future and requires us to make predictions in order to attempt to answer it properly. This is obviously more difficult and the American baseball coach and wit, Yogi Berra, put it well when he said that predictions should never be made, especially about the future.

Undeterred, I believe that we can make at least a broad attempt to assess the likely range of losses our market will sustain over the current default cycle based on:

- the fact that we have very detailed and up to date information on the current performance of a high proportion of the underlying borrowers in the market through our ongoing receipt of monthly management accounts for the Avoca portfolio; and
- the fact that we are now probably at least half way through this current credit cycle means we now have good visibility on the companies and sectors where defaults and losses are ultimately likely to lie.

Assessing likely losses on any debt product requires assessing, first of all, defaults and, secondly, recoveries on those defaults.

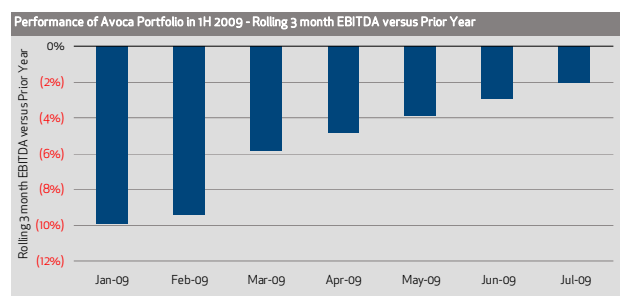
Defaults

A couple of key points are relevant here.

- Defaults are caused when i) companies do not have enough cash to pay their debt obligations as they fall due and ii) the long term economic value of the business is likely to be lower than current debt levels
- Companies whose Operating Profits and Cashflows are stable and/or growing and have reasonable leverage are in our experience unlikely candidates for default as they generally do not meet the above criteria

When we analyse the current performance of the overall Avoca portfolio of approximately 105 European companies spread across 25 or so different sectors, we find that Avoca Portfolio performance has stabilised from February through August this

year with median EBITDA increasing from down 9% on prior year in February to down 2% in July/August.

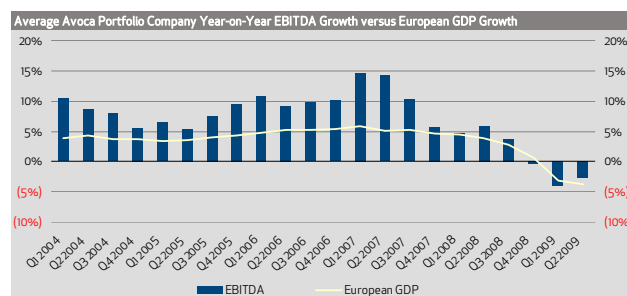


Source: Avoca Deal Database

Investors might at first glance be surprised to learn that the average Avoca portfolio company is only 2% down on prior year at the EBITDA level. After all, are we not just in the middle of the largest recession since the great depression? Shouldn't EBITDA across a diversified corporate portfolio be down 25-30%?

Well, we clearly are in the midst of the deepest recession since the great depression. But just as equity investors should get nominal GDP type returns for equity investments, in the long run (and in our experience interestingly in the short to medium term also), corporate profits tend to track GDP growth.

This has indeed been the case as can be seen from the EBITDA performance of the Avoca portfolio over the past 5 years.



Source: Avoca Deal Database and Bloomberg

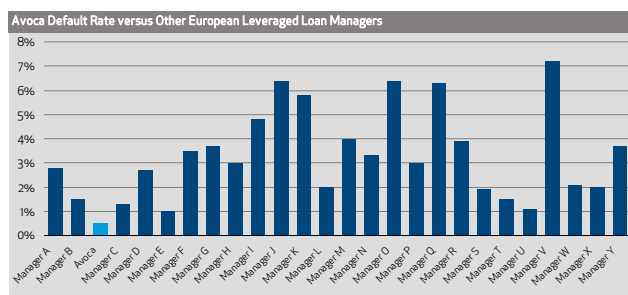
Despite all of private equity's myriad talents in improving portfolio company performance, Avoca portfolio companies (95% of which are private equity owned) essentially broadly tracked European GDP growth (with a little added-on) during what was in hindsight a very benign period for the European and global economies. To private equity's credit, they do appear to have been successful in maintaining EBITDA declines in line with GDP during the downturn despite operational leverage, mainly through the ability to control costs.

“Are We There Yet?”

Through July/August 2009, approximately 60% of Avoca portfolio companies are trading ahead of prior year at the EBITDA level. We believe that defaults in the Avoca portfolio are likely to come from the 40% of portfolio companies trading below prior year. When analysed further, approximately 15% of Avoca portfolio companies are more than 20% behind prior year (mainly comprising companies in cyclical sectors such as chemicals, building materials, industrial equipment etc.).

The 15% of Avoca portfolio companies more than 20% behind prior year are the most obvious candidates for potential defaults over the next 18 months (albeit we do not expect all of them to default) and hence we have consistently forecast to investors that Avoca portfolio defaults are likely to be in the range of 10-15% cumulative through the current credit cycle.

Avoca are currently outperforming the market in terms of cumulative defaults as outlined in the graph below and hopefully we are likely to continue doing so through the cycle.



Source: Citi CLO Monitor, 17 September 2009

When trying to bridge the gap from Avoca portfolio performance to the market portfolio performance, we feel the best proxy is to compare our level of current portfolio defaults and CCC rated loans combined of 12% (3% defaults and 9% CCC rated loans) with the current equivalent figure for the market of 20% (11% defaults and 9% CCC rated loans²). In essence, our problem loans are currently 40% lower than the market.

Taking this into account, we believe that cumulative market defaults through the current cycle will be in the range 20-25%, approximately 40-50% higher than the forecast default range for the Avoca portfolio.

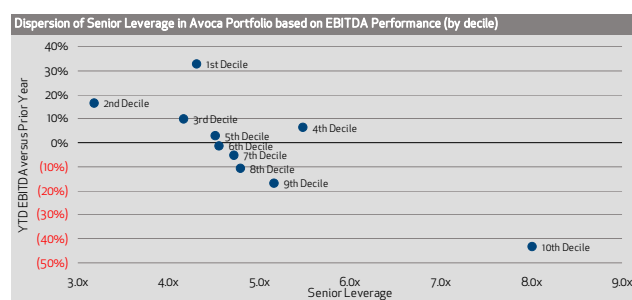
Incidentally, for those who still believe in them, the rating agencies have recently revised downward their default numbers for 2009/2010 combined to be broadly in line with our current estimates of 20-25% cumulative market defaults over that two-year period.

² European Sub-Investment Grade Market - “Leveraged Loan Defaults Continue to Climb In Western Europe”, S&P, 9 September 2009

Recoveries

In analysing potential loan market credit losses the second thing we have to do is estimate recoveries on those loans that do default.

In looking at the worst performing 15% of the Avoca portfolio (i.e. the potential default cohort), they are all trading below prior year and are highly leveraged. As a cohort, this is where our losses are going to come from. The average senior leverage on the worst performing 15% of Avoca portfolio companies is currently 7.0x Last Twelve Months EBITDA.



Source: Avoca Deal Database - as at 28 September 2009

In our Avoca database of approximately 1000 private equity transactions going back over 10 years, the average Enterprise Value purchase price multiple over that period has ranged from 6.0x to 9.0x. At trough in 2002-03 this ranged from 4.0 to 6.0x EBITDA. If we assume that the underperforming cohort of loans likely to default in the market have senior leverage of 7.0x in line with the Avoca portfolio and can be sold at an average 5.0x EBITDA then a reasonable assumption for weighted average market recoveries on defaulted loan assets might be, conservatively, 60 cents in the Euro.

Taking the above default and recovery analysis into account, we suggest that a conservative estimate of market losses is 10% cumulative consisting of 25% cumulative defaults with 60% average recovery on default, resulting in an annual loss charge of approximately 200bps per annum.

Are we there yet?

So where are we exactly in answering our initial investor question?

Here are the facts as we see them:

1. A long term fair return for the European leveraged loan asset class is in the range E+200-250bps net of credit losses
2. The current market is yielding approximately E+750bps before credit losses are taken into account.
3. Cumulative market losses of 10% over a five-year duration would suggest a likely annual loss charge of 200bps per annum.

“Are We There Yet?”

Taking all of the above into account, we suggest that the market is currently likely to yield E+550bps net of credit losses to those who buy the market. We think an experienced, cautious and motivated loan manager should be able to do materially better than the above as this volatile market is currently a very rewarding one for those who are able to attempt accurately measure credit risk.

Avoca has consistently managed to beat the performance of the market since our inception. The Avoca Credit Opportunities Fund, for example, has managed to beat the ELLI Index since its launch in July 2007 by a cumulative 27% (on a like-for-like gross unleveraged basis).

In answering our initial question, we believe the answer is that ***we are not there yet*** i.e. our market still offers fundamental good value to investors for its inherent risk despite its recent 40% rise. Our analysis suggests that there is at least 200bps per annum further spread compression needed to occur before the market hits fair value. This would suggest that a fair value for the market would be approximately 10 points higher today (i.e. 90/92 price range).

Of course the European leveraged loan market is not the only market that remains cheap after the historic heart attack induced on the world financial system by the events of last September (certain CLO liabilities, for example, still remain incredibly cheap). Our job in this letter is not really to assess the relative value of leveraged loans versus other asset classes, a topic beyond a 5-page newsletter but to assess fair value for the asset class we know best and have worked in for nearly 15 years now.

In assessing the relative merits of the European leveraged loan asset class it may be useful to bear in mind that it also offers (unlike its nearest competitors in the government and corporate bond markets) a good hedge against rising inflation through its Euribor exposure. In making this assertion one has to believe that the medium to long term inflation fighting credentials of the ECB remain intact, something we here in Avoca would be willing to take a bet on.

Alan Burke
Chief Executive