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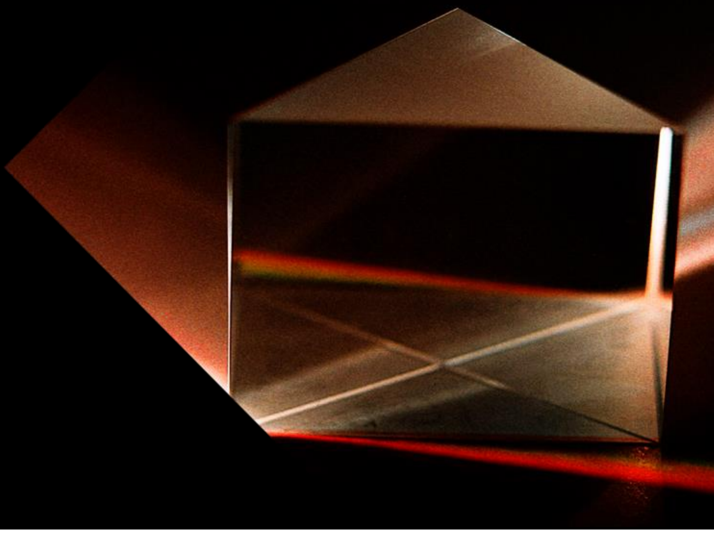

Understanding the role of Capital Solutions

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In an uncertain macroeconomic environment, Borja Azpilicueta, Head of Capital Solutions at HSBC Asset Management, explains how bank-originated assets can enhance returns for institutional investors.

What is Capital Solutions and how does it provide investors with access to bank-originated assets?

The Capital Solutions (CS) team is part of HSBC Asset Management's Alternatives business. Capital Solutions provides institutional and wealth clients access to proprietary deal flow originated by HSBC Bank. The business invests in scalable asset classes where HSBC has differentiated origination and underwriting capabilities and a proven track record across market cycles. Through an arms-length governance framework, Capital Solutions provides an additional layer of independent asset selection, ensuring alignment of interest with investors.

Over the past 12 months, the team has developed and launched two strategies providing institutional investors with access to proprietary alternative credit assets originated by HSBC Bank.

What Capital Solutions strategies does HSBC Asset Management offer?

The CS products launched to date include the Revolving Credit Facility (RCF) and Net Asset Value (NAV) Financing strategies. A potential third strategy, Trade Financing, is being explored to capitalize on growing investor demand for short-dated, investment grade quality private credit instruments, leveraging HSBC Bank's global Trade Finance platform. The Trade Financing strategy is targeting a launch in the first quarter of 2025.

RCFs are revolving loans that provide operational liquidity to corporates. As an asset class, they have low historic default rates and have proven to be resilient through the cycle. In the case of sub investment grade RCFs, these are a higher-yielding alternative to traditional private credit strategies, benefitting from low exposure to interest rate movements.

Our NAV finance strategy provides senior loans secured against the value of quality, seasoned private equity portfolios. NAV loans are high-yielding private credit instruments, with three-to-four-year average maturities and benefiting from downside structural protections We expect the majority of the loans to have an external Investment Grade (IG) rating. In an environment where investment periods are likely to extend, NAV finance allows a borrower to drive portfolio growth and value creation.

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A potential third CS capability being explored is Trade Financing. HSBC Bank is one of the largest trade finance providers in the world and we believe the asset class can provide investors with access to high quality, short-dated, investment grade trade assets.

What makes Capital Solutions strategies an attractive asset class for institutional investors?

In short, our strategies allow Institutional investors to capture the illiquidity premium through conservatively structured loans that can enhance yield without compromising credit quality. The strategies have also garnered significant interest among unconstrained investors, such as large Family Offices.

RCFs have proven to be highly resilient during economic downturns with a default rate of around 20 basis points (bps), which is notably lower compared to other credit strategies such as unitranche. This resilience can be attributed to borrowers' need for RCFs to support their operational liquidity such as covering salaries, taxes, and payments to suppliers. Furthermore, RCFs are always either senior secured or super-senior.

The RCF strategy can also benefit from significant size-benefits as it invests in well-established, global businesses, most with EBITDA larger than $200mn. This has proven to be particularly relevant for large institutional investors, as RCFs can potentially generate returns similar or higher than core mid-market direct lending whilst also benefitting from the additional credit protection associated with larger borrowers.

NAV financing facilities sit between the fund assets and fund investors, and benefit from priority access to cashflows generated by the portfolio. Over 90% of private equity funds raised historically have returned all capital to its investors, and as such, NAV lending to these funds represents a stable and potentially attractive investment opportunity. When combined with low LTV levels and portfolio diversification and cross collateralisation, NAV financing can achieve an external investment grade rating.

Where do these assets fit in an investor's portfolio?

RCFs serve as a diversifier for institutional or wealth clients who are already invested in direct lending, by potentially generating similar or better returns from broadly syndicated loans where the borrowers are usually larger scale corporates than those targeted by unitranche strategies. RCFs can also offer lower duration than equivalent term loans. RCFs could also provide regulatory benefits for specific pools of capital, such as insurance capital.

NAV finance could become a core private investment grade credit allocation, providing portfolio diversification vs. existing private equity and core credit holdings. NAV finance can provide similar returns to sub-IG term loan strategies, but in a shorter maturity and with an IG credit profile, potentially offering a premium of 300-500bps compared with other similarly rated liquid credit instruments.

Trade finance is self-liquidating, so its maturity period is short. Its semi-liquid structure fits into strategic asset allocation as part of a liquidity-plus or strategic liquidity allocation.

For regulated pools of capital, the combination of an investment-grade rating, short duration, and a 200bp yield, makes the asset class potentially attractive for portfolio construction.

Which geographies have you seen the most uptake for these strategies?

We have had interest from European, Middle Eastern, and Asian investors with international allocations. Our investor base is typically exposed to US dollar and many of them are well versed in private credit strategies. For these investors, RCF and NAV provide diversification benefits without changing their risk profiles.

What makes HSBC Asset Management a good provider of Capital Solutions products?

Each of the Capital Solutions strategies have launched in partnership with HSBC Bank, providing the business access to one of the world's largest balance sheets and proprietary deal flow. Across asset classes, HSBC Bank has a historical prudent and conservative underwriting process, resulting in a deep and high-quality client book. HSBC is one of the leading leveraged finance houses in Europe with a demonstrable track record through the cycle. For NAV financing, HSBC runs a leading fund finance platform with a track record of over 20 years and global origination capabilities.

HSBC Asset Management has visibility of the entire private equity ecosystem, ranging from fundraising, financing and refinancings, giving it extensive oversight over deal flow and allowing our business to be highly selective when investing.

The structure of HSBC Asset Management offers two additional benefits. First, the combination of our origination agreement with HSBC Bank and an independent fiduciary and governance framework. Our senior team has more than 20, and sometimes 30 years of experience, and can provide an informed and balanced view of the market. We understand how to triangulate risk, how the assets behave in a downturn, and how to construct a portfolio with limited exposure to cyclical sectors.

The second benefit is that the Group has skin in the game, as an investor in the strategies. This aligns the Group interests with those of external investors.

What is the outlook for these strategies for the rest of 2024 and beyond?

Several key trends are expected to shape the market in the coming year. While the macroeconomic landscape has started to show signs of recovery, a level of uncertainty still needs to be factored into our investment considerations. We adopt a heightened level of diligence, carefully considering external factors, such as potentially persistent inflation levels, supply chain risk and shifts in consumer spending patterns. Our investment approach remains highly selective, but we have continued to be able to deploy capital into high quality assets.

A combination of flat economic growth and still elevated interest rates may continue to put pressure on assets across the market in the near term. Our strategies focus on investments which have proven to be resilient over the economic cycle, as shown by lower default rates in comparison with other private credit asset classes. This resilience stems from the downside protections these strategies offer. RCFs typically target larger, more established corporate borrowers with diversified operations, while NAV financing benefits from being secured against a broad portfolio of underlying assets. These protective features can help mitigate default risk, even in challenging economic conditions.

Potentially, we expect our strategies to generate attractive returns on a relative basis even in a declining interest rate environment, which may affect returns across private credit assets. Our strategies allow lower dependency on base rates, as is the case for the RCF strategy, or capturing the illiquidity premium, as is the case for NAV finance.

Looking ahead, businesses will continue to require capital, and often in new formats. Banks have been refocusing and prioritizing specific asset classes and certain types of clients. This creates a valuable opportunity for managers like us who partner with banking platforms but also work directly with sponsors and other market participants.

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