M&G INSTITUTIONAL

Specialty finance: Investment in action

September 2018

Rising regulatory capital requirements in the banking sector since the financial crisis have created an opportunity for institutional investors to selectively acquire pools of performing consumer loans.

These highly diversified portfolios, for example of residential mortgages, credit cards, auto loans, student loans, unsecured consumer loans, can offer attractive risk-adjusted returns and complement existing private debt investments. Here we illustrate the process through a range of recent transactions for the M&G Specialty Finance Fund (the 'Fund'), which was launched in early 2018.

The value of investments will fluctuate, which will cause fund prices to fall as well as rise and you may not get back the original amount you invested.

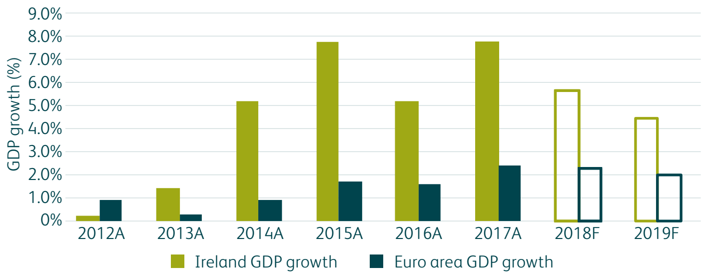
Irish mortgage portfolio

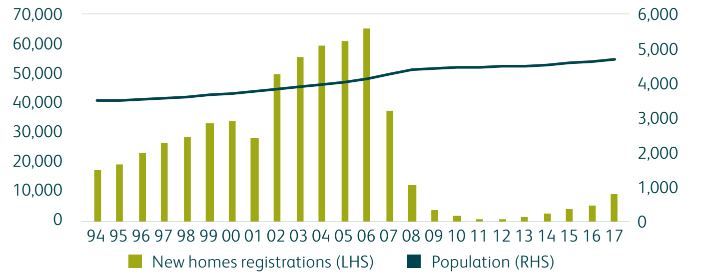
In May 2018 M&G funds acquired a €1 billion pool of Irish residential mortgages sold by Bank of Scotland (part of Lloyds Banking Group). The pool will be financed by working with relationship banks to securitise the loans (expected September 2018), into higher rated/ lower-risk senior and mezzanine tranches and a residual equity tranche (c. €36 million), which will be retained by M&G funds.

We expect this residual tranche to generate an IRR of 9.5% under our base case, using conservative underwriting assumptions regarding expected losses and cumulative prepayment rates on the underlying mortgages, and the anticipated cost of securitisation financing.

We complemented portfolio assumptions with detailed analysis of Ireland's macroeconomic, demographic, housing and mortgage market trends to fully examine the factors that may impact potential returns from the investment. We also conducted exhaustive due diligence on all stages on the management and origination of the underlying mortgages, such as on the loan servicer's collections and servicing capabilities and the originator's underwriting criteria and legal documentation.

Favourable Irish housing market conditions: strong economy and low new home registrations





Source: M&G, European Commission; Davy Economics (top); Ireland Central Statistics Office (bottom), as of 31 December 2017

Risks associated with this fund

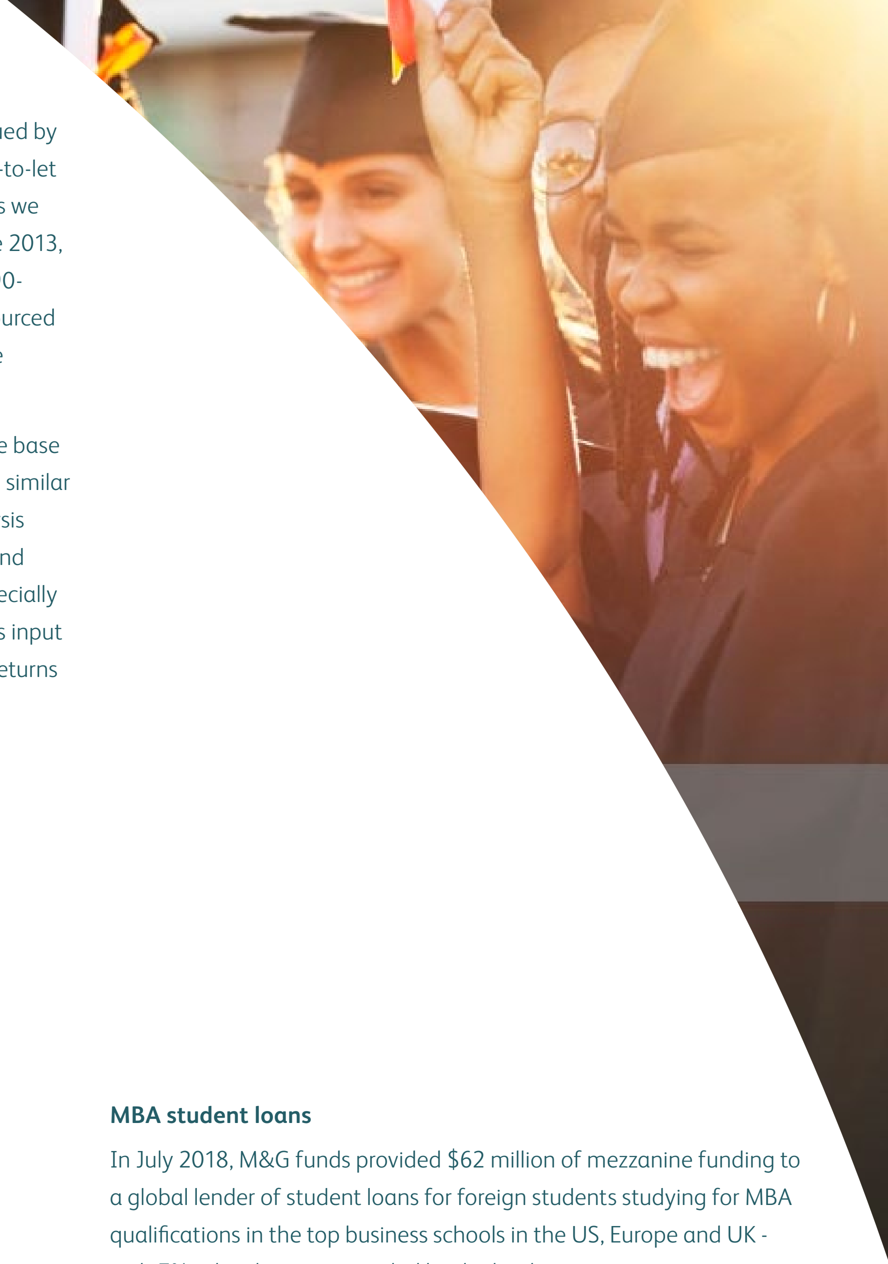
- Credit risk: The Fund may be exposed to the possibility that a debtor will not meet their repayment obligations.
- Liquidity risk (closed-ended): The Fund's investments may be illiquid, as a result it may be difficult for the fund to realise, sell or dispose of an investment at an attractive price or at the appropriate time or in response to changing market conditions.
- Concentration risk: Due to a limited number of investments, the Fund may be affected adversely by the unfavourable performance of a single issuer.
- Derivative risk: The use of derivatives for non-hedging purposes may expose the Fund to a higher degree of risk and may cause larger than average price fluctuations.
- Currency risk: The Fund may be exposed to currency rate movements.
- Equity risk: As equity is subordinate to all other claims into an underlying investment, the Fund may be exposed to the possibility of a low or zero recovery on some of its investments.
- Prepayment risk: Loans may be prepaid by issuers at short notice, as a result it may be difficult for the fund to locate and reinvest capital at an attractive price or at all, which may affect the Fund adversely.

Please note this is not an exhaustive list, you should ensure you understand the risk profile of the products or services you plan to purchase.

UK prime residential mortgage-backed securities (RMBS)

M&G funds purchased the equity tranche of a securitisation issued by an experienced originator of prime UK owner-occupied and buy-to-let mortgages in June 2018. The originator is well known to M&G as we have participated in more than 10 of their RMBS issuances since 2013, across the whole capital structure, with zero losses to date and 90-day plus arrears running at less than 1%. This investment was sourced directly via our bilateral relationship with the bank arranging the securitisation on behalf of the originator.

In order to value this investment – which is expected to generate base case returns of 9.5% IRR - we used our experience of investing in similar deals from this originator and others to conduct extensive analysis on the underlying pool. In particular, we spent significant time and resources analysing the prepayment rates of the borrowers, especially around the time of expiry of the initial fixed rate, to calibrate this input for our modelling as this is the most significant determinant of returns for this deal.



MBA student loans

In July 2018, M&G funds provided $62 million of mezzanine funding to a global lender of student loans for foreign students studying for MBA qualifications in the top business schools in the US, Europe and UK - with 7% subordination provided by the lender.

More than 90% of the current borrower base attends the top global schools borrowing at relatively high rates of Libor + 6-7%, owing to foreign students being underserved by lenders, for example compared to the domestic US student loan market. M&G's funding will facilitate total lending of up to $330 million (in USD, Euro, GBP) over the next two years, to a positively selected borrower base which has much better employment prospects and higher post-graduate salaries than average.

As part of our analysis for this investment, we undertook a detailed analysis of the lender's current loan book which showed a high majority of the loans being repaid on time or early. Cumulative default rates of less than 5% for all student cohorts since 2010, and a delinquency rate of less than 10%, gave further comfort of the lender's loan criteria.

Our base case assumptions of cumulative default and recovery expectations are more conservative than what has been experienced on the existing loans and our due diligence of the platform extended to a site visit to their head office in South Africa and the back-up servicer. Dependent on the nature and timing of our exit from this investment, we expect an IRR of 9.5% - 13%. If the lender issues a securitisation to replace its current senior and mezzanine financing, as expected, M&G's return is anticipated to be at the higher end of this range.

The emergence of specialty finance in the UK and Europe

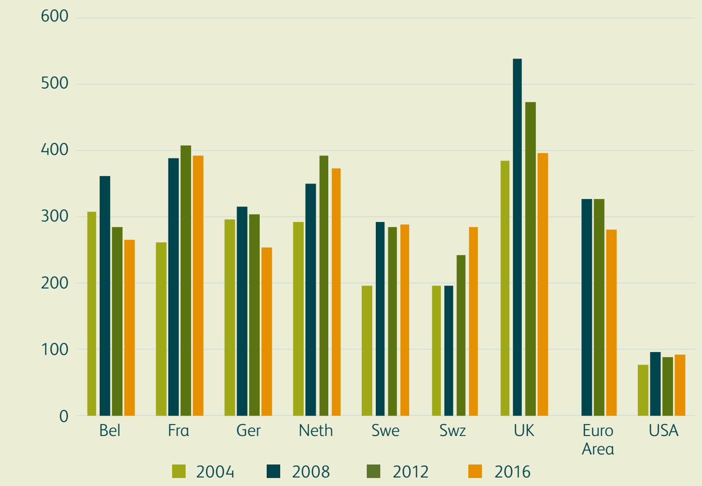
The investment opportunity in performing consumer loan portfolios is relatively new in UK and Europe and results from retail banking assets being disposed of by local banks due to the increase in regulatory capital they must now hold against these assets on their balance sheets. This has the effect of reducing returns from these assets - incentivising banks to sell them to third parties to free up capital for further lending.

At the same time, the availability of finance to non-bank lenders to fund acquisitions or origination of these loan pools has also improved. A non-bank lender such as the Fund can structure a loan pool, for example by issuing a securitisation to source third-party financing for the senior tranches while retaining the highest-yielding junior and 'equity' tranches.

Outstanding loans by type in Eurozone and UK

Source: Bank for International Settlements, 'Structural changes in banking after the crisis', national data, as at January 2018

Banking system assets as share of GDP



Source: M&G, national data, as at January 2018

Structuring and acquiring consumer loan residuals requires extensive analysis and scenario modelling to assess value and likely losses. It also requires the buyer to have access to deep pools of finance. For asset managers with the expertise to both undertake such analysis and finance the transactions, this represents a compelling emerging asset class in Europe, which we expect to grow steadily in the coming years as retail bank deleveraging continues apace in response to increasing banking regulation such as Basel IV.

Specialty finance is a well-developed investment proposition in the US where the capital markets allow for less reliance on retail banks to originate and to retain consumer loans on their balance sheets. As a result, US banks are relatively smaller compared to the size of the economy, more profitable and better capitalised, with shareholders rewarding them with better valuations than their European counterparts. The emerging specialty finance market in Europe gives early investors an opportunity to benefit from the same structural change in UK and Europe.

Contact

United Kingdom

Andrew Swan
+44 (0)20 7548 2375
andrew.swan@mandg.co.uk

Henry Barstow
+44 (0)20 7548 3469
henry.barstow@mandg.co.uk

John Atkin
+44 (0)20 7548 3466
john.atkin@mandg.co.uk

Sunita Dey
+44 (0)20 7548 3393
sunita.dey@mandg.co.uk

www.mandg.co.uk/institutions

institutional.clients@mandg.co.uk