GENERALI INVESTMENTS

EUROPEAN SMES: A rich tapestry of sustainable private debt opportunities

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MARKETING COMMUNICATION FOR PROFESSIONAL INVESTORS IN IT, FR, AU, DE, ES
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The diversity of the SME segment in Europe offers investors access to a highly differentiated and steady flow of investment opportunities, explain the private debt team at Generali Asset Management. Moreover, falling interest rates are expected to benefit M&A corporate loans activity, while flexible unitranche structures from private debt funds should come back into focus.

- The SME sector in Italy, France, Spain, and Germany encompasses over 12 million companies, generating more than half of Europe's GDP.
- As interest rates decline, a "*soft landing*" is expected in M&A transaction numbers, which could positively affect transaction volumes for corporate loans.
- Lower rates means more expensive but flexible unitranche structures from private debt funds may come back into focus, particularly in the SME segment.
- A key feature of our European private debt strategy is the ability to invest in both club loans with banks and unitranche loans, allowing for maximum investment flexibility.

SMEs are the backbone of European economies

Whether it's industrial expertise in Germany, craftsmanship for luxury goods in Italy, or food and electrical engineering in France, Europe, with its diverse economic drivers and specialized industrial sectors, offers investors a uniquely heterogeneous market, opening up a wide range of investment opportunities in private debt funds for SMEs.

The SME sector in Italy, France, Spain, and Germany encompasses over 12 million companies, generating more than half of Europe's GDP. In Germany, where SMEs are often referred to as the "German Mittelstand," these companies represent 99% of all businesses, contribute 50% to economic output, and account for 60% of all jobs.[1] This diversity offers investors access to a highly differentiated pool of companies when constructing portfolios, providing a steady flow of investment opportunities, highlighting the sector's importance in portfolio construction.

For decades, the SME sector was heavily reliant on traditional bank financing. However, since the 2008 financial crisis and the resulting stricter banking regulations, lending to SMEs has become more restrictive. In this context, credit funds have emerged as private lenders and an alternative form of capital procurement. Companies have found reliable financial partners in this type of financing, while investors have benefited from an attractive risk-return profile compared to other asset classes in a low-interest-rate environment. By supporting SMEs, the backbone of many economies, private debt investors have also contributed to creating sustainable and competitive economies.

Soft landing expected with lower interest rates for M&A transactions

The high-interest environment of recent years, combined with geopolitical uncertainties, recession fears, and strong inflation, has led to significant uncertainty and a slowdown in M&A processes and corporate financing in the SME sector. The number of leveraged buyouts and refinancing transactions has particularly decreased compared to the boom years following the 2008 financial crisis and the start of the low-interest phase. Private lenders and banks have recently become more selective, and capital commitments from investors in private markets have also decreased. Some private equity funds even held individual assets longer than originally planned through so-called "continuation funds" to exit under better market conditions or benefit from continued value creation in their portfolio companies.

In the unitranche structures offered by private debt funds, the recent rise in interest rates has shown that they are once again competing with or being refinanced by cheaper bank loans when companies reach a bankable debt level. As interest rates decline, a "soft landing" is expected in M&A transaction numbers, which could positively affect transaction volumes for corporate loans. The lower rates allow companies to better meet their financing obligations, increasing the supply of corporate financing and enabling M&A processes. At the same time, it is expected that lower interest rates, due to a lack of investment opportunities, will positively impact capital commitments from investors in private markets, and more expensive but flexible unitranche structures from private debt funds will come back into focus, particularly in the SME segment.

A lower Euribor rate will affect the total return of a direct private investment, which includes Euribor 3/6 months plus margin and upfront fees. However, it also reduces the issuer's interest payment outflow and therefore improves the company's liquidity profile, all else being equal. All in all, the risk-reward ratio of a corporate private debt instrument should remain attractive and compelling in absolute terms and relative to the fixed income market in a lower rate environment.

In private debt, a strategy in which investors aim for capital preservation and solid income generation, SME investors benefit not only from in-depth credit analysis but also from strong, tailored credit terms. Particularly, the "covenants-lite" structures often seen in the large-cap sector are largely unknown in the SME segment. Instead, lenders secure early intervention and termination rights through covenant agreements in case of deviations from the business plan. Restrictions on financial metric adjustments (so-called "adjustments") are now market standard, leading to broad protection of credit commitments and increasing the attractiveness of the asset class for SME investors.

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[1] Source: BMWK - The German Mittelstand as a model for success

Private debt as an "all-weather" asset class with the right strategic focus

Private debt is no longer a niche market and enjoys great popularity among many investors due to its attractive risk-return profile. Advantages such as the illiquidity premium, low correlation to other asset classes, diversification effects, strong collateral through tailored credit structuring, stable performance, low volatility, moderate default rates, protection against interest rate risks, long durations, or a broad investment spectrum in the SME sector are just a few examples. Despite all these benefits, the asset class also involves a certain level of complexity, where selecting the right asset manager and the underlying investment strategy is crucial.

Generali Asset Management: European private debt specialists

The linguistic, cultural, and economic diversity of European countries requires specialized local expertise. At Generali Asset Management, we have experts with Italian, French, German, and Spanish nationalities and a local investment approach to avoid the pitfalls of a centralized strategy. The diverse experience of our senior investment team in banking, private debt, equity, and debt advisory allows us to leverage specialized expertise in credit analysis, structuring, and later credit monitoring. Continuous portfolio monitoring by our investment, risk, and dedicated ESG teams is also critical to the success of our credit commitments.

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Additionally, we benefit from Generali's established brand and the extensive history of the Generali Group, with access to its indirect private debt and private equity network, often allowing us to collaborate directly with other private debt or private equity firms for a more comprehensive and diversified approach to identifying investment opportunities.

One key feature of our European private debt strategy is the ability to invest in both club loans with banks and unitranche loans, and at a lesser extent, in junior debt. This allows for maximum flexibility in selecting our investments in SME loans. Currently, and thanks to internal and external LPS, our AUM exceeds €540m through two strategies and we are still in the early phase of the investment period with eight deals having been closed in Europe. Unlike competitors whose investment periods are ending, we have no investment pressure, allowing us to invest selectively.

We have ample capital, a strategic timeline, and strong support from the Generali Group with established infrastructure in investment teams, legal, compliance, and back-office functions to create value for investors.

The "affectio societatis" in SMEs and sustainability through ESG

As part of our private debt strategy, we focus on financing medium-sized companies that are striving to improve their ESG profile as a sustainable competitive advantage.

In addition to the diversity and size of the SME segment as an advantage for a broad investment spectrum, we also repeatedly find that management teams of medium-sized companies generally have a stronger 'affectio societatis' – they are simply more motivated to achieve something positive with their companies, which they have often built up over decades. A private debt approach to supporting this objective is often based on the joint development of ESG targets that result from a dialogue between the company, its shareholders and our ESG team. These jointly developed targets are then closely monitored in consultation with the company's management team. Examples include reducing greenhouse gas emissions or lowering employee turnover. The results achieved not only serve as a sustainable competitive advantage, but also as a trigger for an interest margin adjustment, which creates an additional incentive for portfolio companies to achieve the agreed ESG targets.

The objective of the Fund is to realise attractive risk-adjusted returns, providing stable income, by investing primarily in euro denominated floating senior secured loans or bonds and unsecured corporate loans or bonds (subject to pari passu and negative pledge arrangements) made to, or issued by European small and mid-sized businesses in accordance with the terms of this Supplement and the requirements of the RAIF Law. The product is actively managed without reference to a benchmark. Risks of the Fund (non-exhaustive list): Market risk, interest rate risk, currency risk, credit risk, volatility risk. Risk of capital loss: This is not a guaranteed product. Investors may risk losing part or all of their initial investment. This is not an exhaustive list of risks. Other risks may apply. Various costs apply and may change. For more information on risks, maximum costs, and the frequency of cost calculations, please refer to the Issuing Document, available upon request from the AIFM. The fund promotes environmental or social characteristics under Article 8 of Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector ("SFDR"). It does not have sustainable investments as its objective. Please read the Issuing Document, its SFDR appendix and the SFDR website product disclosures to consider all characteristics, objectives, binding elements of the selection process and methodological limits. A summary of the SFDR website product disclosures are available upon request at the AIFM. The future performance is subject to taxation, which depends on the personal situation of each investor and which may change in the future.

IMPORTANT INFORMATION
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