Q&As on H2O's exposure to non-rated private placements

The case for H2O Adagio, H2O Allegro & H2O MultiBonds

H2O Asset Management

1) Non-rated corporate bond exposure calibration & risk/return benefits

- As clearly indicated on page 2 of our monthly factsheets, the current exposures of H2O Adagio, H2O Allegro, and H2O MultiBonds to non-rated corporate bonds amount to 4.3% 9.7%, and 8.3% of these funds' net assets as at 20/06/19[1].

  As a reminder, H2O's positions are mostly financed through futures contracts and currency forwards, which makes a lot of cash available in the funds (e.g. cash & money market placements at 56% in H2O Adagio).

  Also, in terms of commitment and risk consumption, these exposures are marginal in comparison with those generated by our global macro views on sovereign bonds and currency markets.

- The calibration of these exposures is binary in the sense that the lower volatility UCITS are app. 5% exposed, and the higher volatility ones are app. 10% exposed;

- Today, this exposure in turn splits across nine (9) issues ranging from 0.2% to 2.7% of net assets per fund. These include:
  a. Chain Finance 7.75% 2020 collateralized by Sapinda Group portfolio companies including Smashcast (the world´s largest independent E-Sports internet broadcasting platform outside of Asia), Avatera Medical (a German medical equipment manufacturing company specializing in robot-assisted surgery devices), and Fyber N.V. (a mobile-phone advertising technology company);
  b. Civitas Properties Finance 4% 2022, backed by German residential real estate;
  c. DeGros Holding 6.5% 2023, issued by a logistics services cy. operating in Germany;
  d. ADS Securities Funding 6.5% 2023, a Abu-Dhabi-based financial services company;
  e. La Perla Fashion Finance 7.25% 2023, the renowned Italian luxury-lingerie maker ;
  f. Trent Petroleum Finance 8.5% 2023, an energy cy. operating oil fields in the North Sea;
  g. Everest MedTech B.V. 5% 2024, backed by Avatera Medical (see above);
  h. Voltaire 7% 2023, Wild Bunch, a French film distribution company;
  i. Rubin Robotics B.V. 5% 2024, a convertible bond collateralized by Avatera Medical.

[1] These exposures have been systematically and fully disclosed in our monthly factsheets, in the fund's semi-annual & annual reports, and in regular notes issued by H2O in February, August and October 2018, as well as more recently in May 2019. They have from time to time been discussed in client meetings. It was never H2O's intention to hide these investments away from our clients' knowledge and scrutiny.

- These private placements are "Lars Windhorst-related" in the sense that the bond offerings have indeed been referred to us by Lars Windhorst whose holding company, Tennor Holding (previously known as Sapinda Holdings), owns the issuing corporations equity wise, save for ADS Securities;

- The above companies which are managed independently issue private bond placements with a seniority linked to a fixed income investment, and with distinct guidelines (covenants, collateral and coupons). H2O is exposed to these private placements which are all securitized with unique ISIN codes;

- These private placement securities offer a similar profile as that of collateralized securities where cash flows are distributed regularly and bonds repaid at maturity. In case of a credit event, these bonds may deliver lower coupons or have their maturities extended;

- H2O's private placements relate to totally independent European companies ranging from a German medical equipment manufacturer to an Italian luxury lingerie maker, and include film distribution, oil field operations, real estate and e-commerce among other sectors. As a consequence, they expose the funds to a portfolio of diversified high-yielding short-dated bonds that can be either traded later or held to maturity, even though we rely for the time being upon one single referral agent (more below);

- These securities provide genuine diversification from our other (sovereign & corporate) fixed income positions especially when our funds incur drawdowns in risk-off market environments;

- For reasons explained hereunder, H2O may have decided to buy significant amounts of the bonds issued by the above listed companies to increase the ability to negotiate better terms with detailed information. The holding ratios per issue and per fund are monitored to be aligned with the regulatory 10% ceiling.

2) Contribution to performance

- Since 2015, these private placements have provided a significant source of diversified carry, at the logical expense of liquidity. Please find below their contribution to the performance of H2O Adagio, H2O MultiBonds, and H2O Allegro since 2015:

	2015	**2016**	**2017**	**2018**	**2019**
H2O Adagio	0.22%	0.29%	0.87%	0.75%	0.17%
H2O MultiBonds	0.23%	0.17%	1.55%	1.70%	0.36%
H2O Allegro	0.42%	0.15%	1.18%	1.34%	0.13%

Data as of 20/06/2019. Source: CACEIS & H2O

3) The H2O-Lars Windhorst partnership

- Lars Windhorst has over the past four years referred valuable investment opportunities to us, and has proven to be a reliable business partner. In addition, the constructive collaboration that we have built over time has enabled us to enter into transactions on terms which we would consider favourable for our funds. In line with our investment process, we like to calibrate our strong convictions on few but fairly sized positions;

- H2O has been offered to subscribe for short-dated (maximum 5 years) bonds issued by these different European corporations. In this respect, Tennor's and H2O's interests are fully aligned. There is no financial remuneration/compensation between the two companies in any shape or form at a personal or corporate level;

- This does not imply that H2O invested in these deals blindfolded. Back in 2015, following the arrival of corporate-credit specialist Pascal Dubreuil in the investment management team, the decision was taken by the company's Executive Committee to increase and diversify its portfolios' bond holdings away from govies into corporate bonds (AT1 & Cocos), including private-equity-kind of placements. The choice was made to opt, not for the then expensive, highly intermediated, and crowded US market, not for the UK one that was getting engulfed in PM Cameron's 2016 Brexit referendum decision, but for the European one that offered very good value but much less liquidity;

- Due diligence investigations have been conducted in situ by H2O to assess the business plan and the creditworthiness of the companies targeted. For instance, Pascal Dubreuil travelled to Bologna last year to inquire on La Perla: ditto for Avatera in Jena, Germany. Last but not least, as a major investor in these deals, H2O is totally involved in the negotiation of the covenants and of the level of collateralization of the bond issues;

- Earlier this year, Bruno Crastes requested the setting up of an Advisory (non-Executive) Board at Tennor Holding on which he is now sitting. This move was justified based on the need to closely monitor H2O's investments in these different companies in terms of governance. Bruno Crastes carries no personal interest in this position: no remuneration, no contract, and not intervention in the running of the companies. On this Advisory Board, no confidential information is shared ;

4. Valuation Policy

The H2O FCPs valuation policy is entrusted to CACEIS Administration, the funds accountant, and relies on available market prices quoted by third parties. For listed derivatives, they are extracted out of exchanges. For OTC products, valuations may be obtained from counterparties or third party pricing sources, as per the requirements of UCITS Directives. When such prices are not available, H2O's Valuation Committee, which is totally independent from the portfolio managers, decides on the best valuation methodology or on the appropriate pricing sources so as to publish a fair value of the related security as per the UCITS directive requirements.

Out of the nine bonds enumerated on page 1, five are Level 3 securities, meaning that they are:

- ✓ either not listed officially *(this is not related to the fact that they are not rated)* so their price has to be assessed daily by H2O's Risk Department in accordance with its Fair Value Pricing policy, and submitted to CACEIS;
- ✓ or listed but discounted by H2O.

The daily quotations of these securities are sent to CACEIS Administration via the so-called "Price List."

Out of these five bonds, three (Chain, DeGros & Trent) are listed (Bloomberg quotation), but they are voluntarily discounted by H2O, 5% to 15% off their Bloomberg quotations in order to increase their liquidity premium and to protect the fund's shareholders in the case of market liquidity traps.

The two others (Everest and Rubin) are not listed and thus valued by H2O at a discount.

In H2O Adagio, the exposure to Chain, DeGros, Everest, Trent and Rubin Robotics amounts to a total of 2.8%, 6.5% for H2O Allegro and 5.8% for H2O MultiBonds as of 20/06/2019;

H2O's Fair Value Pricing policy is conducted by the credit management team. Based upon our expectations of future cash flows, it consists in quoting these private placements in-between their issue price (at which they will very likely be reimbursed at maturity) and their stressed price in the case of early redemptions in dire market liquidity conditions.

5. Liquidity of the funds

The Risk department at H2O monitors the liquidity risk of all portfolios by estimating the cost of liquidating a proportion of the portfolio within different time frames.

Under normal market conditions, the cost of liquidating a portion of the portfolio is based on the prevailing bid-ask spreads.

To compute the cost of liquidating a portion of a portfolio under extreme market conditions, the risk department partitions the portfolio into different categories and applies a discount to all assets based on their respective category. The discount is calculated based on the widest mid-bid spreads observed between 2010 and 2019.

As of March 29th, 2019,

H2O MultiBonds	Relative loss (in basis points)		
	20% redemption	30% redemption	40% redemption
Normal market conditions	-4	-6	-8
Stressed market conditions	-31	-47	-62

Source: H2O Risk Department.

Please note that a Swing Pricing policy is also in place across most of our UCITS (including H2O Adagio & H2O MultiBonds) so as to activate an equitable allocation of entry/exit costs between the old and new unitholders. It is conducted by H2O's CIO jointly with the Head of H2O's Risk dpt.

Edited by H2O AM in London on Wednesday 20 June, 2019.