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Loans to Dutch SMEs: Attractive returns and a positive impact

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Markets have recovered most of their losses …

The downturn in financial markets as a result of the coronavirus crisis reached a turning point in March. Since then, markets have recovered strongly, with a recovery of around 70%-80% of the losses. This article is a summary of a second webinar (in a series of three) on Alternative Fixed Income and Responsible Investments hosted by Aegon Asset Management. In this webinar, Gerard Moerman discussed SME loans with Frank Meijer and Brunno Maradei. Apart from enhancing return and diversification, these loans can help investors to achieve their social and economic impact objectives.

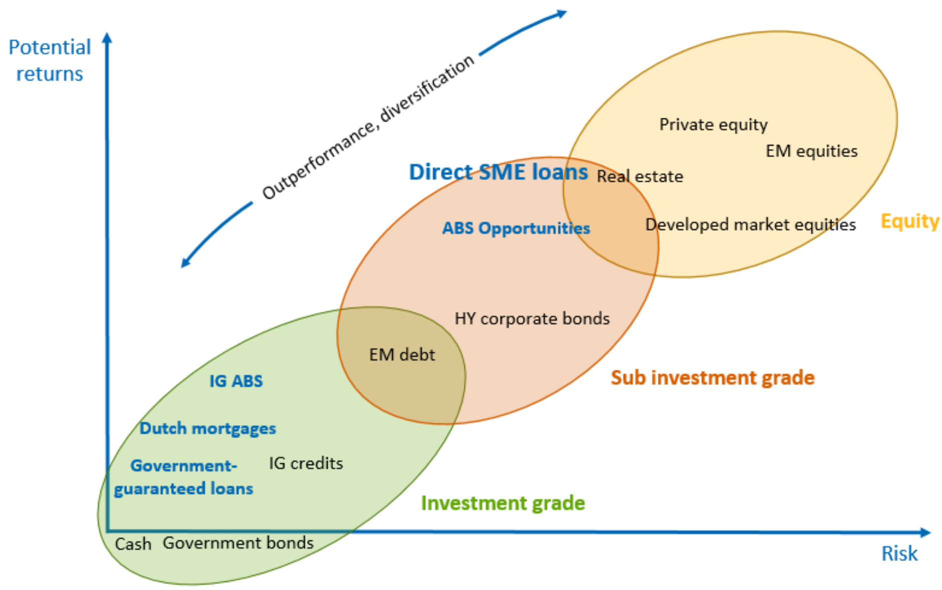
The loans that feature in this seminar consist of subordinated loans to Dutch SMEs. Such loans provide additional financing, on top of senior loans already supplied by banks or other lenders. The strategy to be discussed leads to attractive returns for investors. In addition, the downside risk is reduced by a partial (semi-) government guarantee. This leads to an attractive risk/return profile, coupled with ample opportunities to direct funds to companies offering a positive environmental or social impact. Full details of the conversation can be received upon request.

… but as yields tighten, where's next for institutional investors?

We have just entered the second half of the year. Institutional investors often now begin considering ALM studies and reviewing their asset allocation for the year to come. The coronavirus crisis led to big movements in the financial markets. Spreads reached their highest point on March 23 but, from that point onwards, they have tightened substantially. This implies a possible turning point in the markets, where a short window to buy at elevated spreads may now have passed. However, as long as economic uncertainty remains, some new market opportunities may still emerge in time.

Once again, alternatives stand out as an option to gain additional yield, driven by factors such as illiquidity, size and complexity. In addition, alternative strategies showed resilient performance during the previous market turmoil, offering investors diversification benefits as well as stable returns compared to more traditional investments.

Figure 1: Relative value of alternative fixed income (in blue).



Source: Bloomberg and Aegon Asset Management. Stylistic graphic showing potential risk/return profile of a selection of alternative versus traditional asset classes.

Financial markets have seen robust growth in new opportunities within the broader fixed income space. This has been particularly evident with the growing allocation to fixed income alternatives by institutional investors. Another important trend in the global financial markets is the move towards ESG integration and impact investing. ESG risks can generally be managed very well in alternative asset class portfolios. Furthermore, some strategies are specifically suited for impact-related activities. SME loans are a good example of this, as discussed during this webinar.

SME loans can enhance a portfolio's risk / return profile

Within the alternative fixed income space, three strategies that align responsible investing stand out. In this webinar, loans to small and medium-sized enterprises (SMEs) are discussed in detail. We here consider loans to Dutch firms. Normally these firms have an internal rating at the top of the high-yield universe – most loans have an unrated credit profile around BB (using an approach based on internal risk models). To qualify for investment, companies should have solid revenues, stable cash flows and a reasonably long track record.

Table 1: Dutch SME loans from a relative perspective have a very attractive risk-return profile.

	Leveraged loan	High yield bond	Dutch subordinated SME loans
Coupon type	Floating	Fixed	Fixed
Typical rating	BB / B / CCC	BB / B	**BB**
Typical yield (EUR)	5.5%	5%	**9.5%**
Repayment	Bullet (~5y)	Bullet (~5y)	Fully amortizing (~5y)
Covenants	Mostly covenant light	covenant light	Leverage, other non-financial covenants
Typical Recovery Rate	50-70%	30-40%	**50-70% (incl. EIF guarantee)**
Typical SCR under Solvency II (Pillar 1)	25%	25%	**15%**
ROC (Pillar 1)	20%	20%	**70%**

Source: Aegon Asset Management.

An attractive pick-up in yield can be achieved by investing in SME loans (~9.5%). Apart from the illiquidity premium and complexity premium, the major drivers of return within this strategy are the reduced competition and the willingness from SMEs to get financing in order to materialize their growth plans. The market for Dutch SMEs also has specific barriers that make it hard for non-Dutch investment managers to enter, such as understanding the local habits and the requirement to speak Dutch when negotiating the loan terms with the SME firms. As a local player, Aegon Asset Management not only meets the aforementioned requirement, but has also set up a unique investment model in order to originate SME loans. This investment model was created in a cooperation with both governmental and corporate parties at a C-level, aiming to foster the development of SMEs. Standard inter-creditor agreements with large local financial institutions (i.e. the major Dutch banks) are now in place. This creates an efficient investment process for both parties and, hence, a steady supply of sourcing leads. The process has proven itself in the last couple of years and is now extremely useful in order to support SME growth during the Covid-19 market stress.

The risk-return profile of SME loans is also attractive because the risk of this strategy is considerably less compared with asset classes with similar returns. Important elements here are covenants with the borrowers and the amortizing nature of the loans (which reduces the refinancing risk). In addition, Dutch SME bankruptcies have been low historically and since 2013, the bankruptcy rate has been decreasing on a year to year basis.[1] Furthermore, Aegon Asset Management is the only party in the Netherlands that can offer robust downside protection via governmental guarantees on subordinated SME loans. This guarantee normally covers up to 50% in case of losses. For working capital loans this can go up to 80% protection. Such guarantees significantly lower the downside risks for investors.

Regarding the financial turmoil brought by the coronavirus pandemic, it is also interesting to observe that there was a limited impact on Dutch SMEs. The average economic activity during the height of the coronavirus crisis was still high in the Netherlands, compared to most other European countries. This can be explained partially by the "smart" lockdown in the Netherlands which allowed many firms to continue operating and large support packages by the Dutch government.[2] For example, the SME loans strategy at Aegon Asset Management has not experienced any defaults since inception (almost 5 years ago), even during the current market turmoil. A solid issuer selection process contributed to this, ensuring that companies have a strong profile in terms of history, size, financials and the nature of their business.

Managing ESG-risks and using capital to drive impact investing

Aegon Asset Management's SME loans strategy manages ESG factors in line with international frameworks. ESG aspects are integrated in the investment process, which starts with a thorough due diligence. A tailored approach, including physical meetings, offers us the opportunity to engage with companies and to clarify and address possible ESG issues. A constructive approach is used in this case, both understanding each company's challenges and providing guidance where possible and needed.

Capital invested in SME loans also has a direct positive investing impact by driving innovation and improvements in economic, social and environmental outcomes, in line with the UN's sustainable development goals (SDGs). Specific requirements set by the European Commission are used in the issuer selection and investment process. An indirect effect is also accomplished by ensuring that the loans enable activities that have positive externalities, and thus a favorable environmental and social impact.

SME loans: pragmatic impact investing
Aegon Asset Management has invested in a laundry and textile care services provider for hotels and restaurants. **Direct impact investing** is reached by facilitating means for not only the company's but also local **economic growth**. By financing a new line to double their capacity with a very **innovative approach**, their services can be provided using less than 1.5 L of water per kg of laundry, saving 8 L relative to the (EU) market average. This investment therefore also has a positive **indirect environmental impact**.

Measuring ESG-risk management and impact investing in SME loans is not an easy task. Common challenges have been identified and vary in nature. Reporting impact or ESG data is still challenging, even for experienced and developed companies. Naturally, SMEs often have fewer resources and expertise in this field, making ESG calibration more complicated for them. Also, the diverse nature of companies adds more complexity when trying to define reporting standards. On the other hand, these challenges also bring opportunities. A delicate balance should be found here since the goal of funding SMEs might be hindered by the above challenges. Focusing on collaboration and engaging with companies during the process in a bespoke way has been Aegon Asset Management's approach to these challenges. Doing this also ensures a healthy development of impact measuring and reporting.

Conclusion

The market opportunities presented in March 2020 to buy liquid asset classes at significantly elevated spread levels seem to have largely evaporated, at least for now. A very volatile first half of the year has also passed and, amongst the lessons learned, alternative fixed income stood out as a highly resilient asset class. Looking ahead, alternative fixed income strategies are thus likely to receive even greater attention when institutional investors review their strategic asset allocations.

[1] From 1.44% in 2013 to 0.47% in 2018. Source: CBS MKB Statline. Note that the underlying numbers refer to absolute (not relative) amounts.
[2] Source: ING Research.

Dutch SME loans offer a very attractive yield, driven mostly by an illiquidity and complexity premium and high barriers to entry to this market. The risk-return profile of SME loans is also attractive because the downside risks of the strategy are considerably lower when compared with asset classes with similar returns. Important elements of this protection are covenants with borrowers, the amortizing nature of the loans and downside protection via (semi-) governmental guarantees. Dutch SME loans can also more than justify their inclusion as impact investments, with several examples given during this webinar of the direct and indirect positive impact they can have on ESG factors and on the UN's SDGs.

We hope you enjoyed this second webinar (of three) in the Alternative Fixed Income and Responsible Investment series. The recording of this 2nd webinar is unfortunately no longer available on BrightTALK but if you have any follow-up questions regarding SME loans and Responsible Investments, or how to integrate SMEs in your strategic asset allocation, please get in touch with your regular Aegon Asset Management contact or go to: **https://www.aegonassetmanagement.com/global/about-us/contact/contact/**.

Important information