SQN Asset Finance Income Fund Limited

LEI: 2138007S3YRY3IUU4W39

Investment Update

The Board of SQN Asset Finance Income Fund Limited (the "**Company**") announces that it has received the following investment update from KKV Investment Management ("**KKV**").

Investment Update

In advance of the release of the NAV as at 30 June 2020, KKV is pleased to publish its first investor update for the Company.

Executive Summary

- KKV assumed responsibility for the portfolio on 6 June 2020 and the first NAV announcement since the appointment of KKV is expected on 24 July 2020.

- A number of businesses in both the Ordinary Share class and the C Share class have been impacted by Covid-19 related weakness and have requested forbearance during Q2 2020. KKV has graded the impact and the resilience of each position into four distinct categories; strong, performing, stressed and distressed. Despite IFRS9 guidance urging a pragmatic approach to these circumstances, in the most extreme instances KKV is proposing impairments where the security or business outlook has been materially damaged and that damage is not likely to be transitory.

- It is unlikely that a sustainable dividend can be re-established in the near future. KKV will need to establish clarity around the timescale that project finance transactions can deliver income on a cash basis as opposed to accruals, which is dependent on the extent of the Covid-19 impact and the speed at which borrowers can return to near normal operational capacity.

- Shareholders are advised that an initial analysis of IFRS9 impairment provisions indicate the need for additional provisions of circa £20m to £24m for the Ordinary Share portfolio and £8m to £10m for the C Share portfolio. Over the next two weeks KKV will conduct further detailed analysis so that more precise recommendations for impairment can be provided to the Board for inclusion in the 30 June 2020 NAV.

- The outlook for the next financial year remains volatile. Sensible steps have already been taken to stabilise the portfolio and KKV expects to provide an update as issues within the portfolio are resolved or on a path to resolution.

Ordinary Share Class

- Approximately 40% of the portfolio of the Ordinary Share portfolio is considered 'strong' or 'performing'.
- The balancing 60% is considered either 'stressed' or 'distressed' and KKV proposes further impairments to the loans in this pool by circa £20m - £24m.
- Average contractual maturity of the loan book is 110 months with the longest dated loan maturing in 2037

- Significant percentage of the total impaired assets relate to project finance transactions in the renewable energy sector, representing 22% of Ordinary Share NAV.
- Continued commitments to advances have drawn heavily on cash reserves. However, with the ongoing suspension of dividends we expect the Ordinary Shares to have sufficient cash flow to meet these commitments.

C Share Class

- Approximately 70% of the C Share portfolio is considered ‘strong’ or ‘performing’.
- The balancing 30% is considered either ‘stressed’ or ‘distressed’ and KKV proposes further impairments to the loans in this pool by circa £8m - 10m.
- Average contractual maturity of the loan book is 58 months with the longest dated loan maturing in 2033.
- Availability of cash for dividend distribution has been depleted due to recent commitments of capital to existing borrowers during May 2020 but the pool remains with a satisfactory liquidity outlook.

KKV assumed investment adviser responsibility for the Company on 6 June 2020 after a brief transition period of five weeks. This short time frame was implemented in order for KKV to be in place for the year-end accounts as at 30 June.

For the purposes of this report and in future investor communications, the Ordinary Share class and C Share class will be analysed as separate portfolios.

The report is constructed in three parts:

- An introduction to KKV, its capabilities and business response to the Covid-19 emergency.
- An overview of the lending conditions since the beginning of 2020, including an assessment of the Covid-19 impact on SME businesses.
- An investment review of both Ordinary Share portfolio and C Share portfolio with a particular focus on impaired assets and the impact of Covid-19 on our borrowers.

KKV Investment Management Limited

Despite opening for business during a global pandemic, we are pleased to report that the company was able to commence operational management in June 2020. KKV has the use of three offices in London and Surrey but all employees have been equipped to work remotely throughout the current Covid-19 emergency with the majority choosing to do so. All processes are functioning and business continuity has been maintained to a good level. The transition of SQN employees under the TUPE scheme has been completed and new colleagues have made an excellent start to their new working relationships with former SQN colleagues.

KKV's credentials in the private debt sector are extensive, having successfully turned around the SQN Secured Income Fund since 2017 starting with 95% peer to peer investments that has now been transformed into an SME loan portfolio with dividend cover and zero impairments. With additional resource provided by Ken Hillen, Chris Greener and Christian Holder, the team has a wider background in the commercial loan sector including securitisations and wholesale loan portfolios. Furthermore, we have wide experience of the Investment Trust and alternative lending sectors including structuring, discount management, interaction with boards and client relationship management. Our whole value chain expertise in origination, underwriting, monitoring and administration is also combined with our expertise relating to impaired assets, including work-outs, refinancing and restructuring.

During our first four weeks as adviser to the Company, we have achieved the following:

- Reviewed all the 42 UK and Europe credit names held in the portfolio.
- Commenced implementation of our strategic plan regarding AD plant exposure.
- Targeted stressed and distressed assets as an immediate focus.
- Commenced a review of US credits previously managed from New York.
- Conducted 37 shareholder meetings including a broker analyst meeting in which 13 research analysts participated, delivering on our commitment to provide clear communications for shareholders.

This flying start has allowed us to appraise the portfolio and provide shareholders with our considered view on the outlook for the more challenging parts of the portfolio.

Market Backdrop

Highly volatile pricing of all assets across the risk spectrum and intermittent volatility spikes have been facets of all fixed income sectors during 2020. All credit products fell violently from March onwards and this was particularly severe for higher yielding assets with even US Treasury bonds briefly affected by a liquidity squeeze. Since the introduction of emergency market support packages from central banks, such as the US Federal Reserve, the European Central Bank and the Bank of England, these markets have settled but the economic picture remains uncertain.

As developed economies in the US, UK and Europe begin to ease lockdown measures, market commentators have remained expectant of a so-called V shaped recovery as businesses begin to emerge from their forced hibernation. Our appraisal is more circumspect and despite spreads tightening in recent weeks for investment grade credits, as companies shore up their balance sheets with additional borrowing, we are particularly focussed on data relating to SME performance and securitised products such as CLOs and lower sub investment grade markets where the greatest pain has been observed. We expect coupon obligations to be put under pressure and forbearance to be the watch word for the next 9-12 months.

SME business confidence has fallen sharply and lower turnover due to Covid-19 has caused severe cashflow difficulties for many businesses, increasing demand for working capital finance. This has been coupled with a sharp increase in demand for loans and the uptake of government backed schemes encouraging commercial banks to lend into the sector. Easing of credit criteria for loans by these banks, has a second derivative effect of weakening capital adequacy and it is our expectation that once markets begin to normalise, lending patterns will revert to more conventional levels, allowing alternative lenders to pick up the baton once again.

The speed of recovery is unclear at the present time. By way of stark illustration, unemployment in the US increased by 14 million in six weeks at the height of the Covid -19 emergency whereas the total number of those losing jobs between June 2008 and June 2009 was 3.5 million and it took four years for employment to return to pre-recession levels. Reversal of lost jobs takes time for an economy to absorb and so we expect this to impact consumption and consumer confidence. For lenders and borrowers alike, the safest route to normalisation is to keep sustainable businesses alive with support and forbearance including maturity extensions and interest or amortisation "holidays", to enable them to resume trading and servicing their loans as rapidly as possible; an approach KKV has adopted across its portfolios.

For investors, the reduction in dividend and share buy-back programmes across the equity market landscape, should focus attention on regular coupon paying fixed income strategies. These are contractual and any missed coupons are rolled up, unlike missed dividend payments. Once the current and immediate crisis subsides, regular income will be a highly valued commodity.

Portfolio Update

While the portfolios are focussed on the highest quality loans in the lower middle market segment of the market in sectors that are more commonly uncorrelated to the wider investment markets, the impact of Covid-19 has been felt by most of the Company's borrowers. For some, the collapse in the oil price and reduction in shipping volumes has had a significant impact.

The team has reviewed all credits and embedded risks where full detail is available with around 15% of the portfolio (by NAV) requiring additional review, being those credits that were previously managed from the US and KKV has begun an intensive series of meetings to facilitate a smooth handover as many of these transactions have been restructured and refinanced over the last three years. It is our view that individual credits are likely to under or outperform relative to present levels but the aggregate level of proposed impairments now represents an appropriate level of provisioning, allowing shareholders to have a higher level of confidence in the NAV going forward. It should also be noted that impairment does not necessarily lead to a full write-down, we expect some impairments to be of a temporary nature and that overtime they will return to a performing status after we have reprofiled or restructured the loans. Our reasons for applying additional impairments have been multi-faceted and include:

- A reassessment of security packages supporting loans and the inherent risk that liquidation valuations represent a material shortfall.
- Valuation of equity positions inherited as a result of the restructure of loans in the past.
- Risk assessment of currency exposure embedded within the businesses.
- Near term underlying collateral valuations have been placed under intense strain by Covid-19 with reduced likelihood for full recovery.

During our review process we first ascertained the current credit risk position where non-payment was related to short-term Covid-19 related delinquency we allowed some leniency. We then further reviewed those with stressed or distressed profiles and reviewed likely loss scenarios. Finally, we proposed provisions, where appropriate, to reflect potential losses.

With regard to classification, we have divided all loans into four categories:

- Strong - a loan likely to repay in 0-24 months;
- Performing - all cash flows are likely to be made in a timely manner;
- Stressed - the credit may not pay in a timely manner or a small shortfall is possible;
- Distressed - where a credit workout is underway or highly likely.

	Ordinary Share Class	**C Share Class**
1 Strong	12%	29%
2 Performing	28%	38%
3 Stressed	9%	15%
4 Distressed	51%	17%

Source: KKVIM, data as at 30 June 2020.

As illustrated above, in our view we have identified that 40% of the Ordinary Share portfolio and 68% of the C Share portfolio should be classified as either ‘strong’ or ‘performing’ meaning that they are delivering regular cash payments, have not missed recent payments and the security package is robust enough for us to have confidence that full value can be returned for the benefit of Shareholders.

The remainder, 60% of the Ordinary Share portfolio and 32% of the C Share portfolio are either impaired, have ceased cash payments or are non-cash paying and their security packages do not provide KKV with suitable confidence that their value is sufficient to cover future liabilities. It should be noted that the high level of distress noted in the Ordinary Share portfolio includes impaired valuations of six renewable energy projects and these have been governed by an independent valuation carried out during Q1 2020. A revised valuation is due to be delivered for financial year end as at 30 June 2020 and a material change is not expected.

In observing the performance of the AD Plant investments, smaller projects of 0.5 MW capacity have been largely successful during build and then production phases, with some already sold. The larger projects, aiming to deliver 4 to 5 MW of energy, have been more complex. It is our intention to consolidate and consider the sale of assets where we consider an economic return on investment to be of a longer maturity than is suitable for the Company to hold. However, any sale process will be organised to achieve maximum value for shareholders. A "fire-sale" of assets will not be undertaken.

Portfolios Analytics as at 31 May 2020.

Investment Country

	C	Ord	Total
UK	68%	54%	59%
US	11%	26%	21%
France	5%	9%	7%
Ireland	1%	4%	3%
Mexico	9%	0%	3%
Netherlands	0%	5%	3%
Iceland	4%	0%	2%
Brazil	0%	2%	1%
UAE	2%	0%	1%

Source: KKVIM, data as at 31 May 2020.

Investment Sector

	C	Ord	Total
AD	0%	28%	18%
Diversified Portfolios	18%	13%	15%
Transportation	18%	7%	11%
Environment	21%	0%	7%
Glass	0%	9%	6%
Marine	15%	1%	6%
Solar	0%	10%	6%
Wholesale Portfolios	6%	6%	6%
CHP	0%	6%	4%
Hospitality	0%	7%	4%
Agriculture	4%	3%	3%
Automotive	5%	0%	2%

Cash	6%	0%	2%
Construction	3%	1%	2%
Energy	3%	1%	2%
Medical	0%	4%	2%
Logistics	2%	0%	1%
Paper	0%	2%	1%
Telco	0%	2%	1%
Plastics	0%	0%	0%
VAT	0%	0%	0%

Source: KKVIM, data as at 31 May 2020.

Facility Maturity Date

	C	Ord	Total
< 6 Months	12%	8%	10%
6-12 Months	14%	17%	16%
1-2 Years	6%	2%	3%
2-3 Years	12%	11%	11%
3-5 Years	10%	2%	5%
5-7 Years	19%	19%	19%
7-10 Years	17%	8%	11%
>10 Years	8%	33%	24%

Source: KKVIM, data as at 31 May 2020.

Investment Type

	C	Ord	Total
Loan	67%	40%	49%
Project Finance	11%	41%	30%
Wholesale Facility	15%	15%	15%
Operating Lease	0%	4%	3%
Cash	6%	0%	2%
Bridge	1%	0%	0%

Source: KKVIM, data as at 31 May 2020.

Currency Distribution

	C	Ord	Total
GBP	66%	47%	54%
USD	24%	36%	32%
EUR	10%	17%	14%

Source: KKVIM, data as at 31 May 2020.

The summary below includes an overview of each asset on which a new impairment has been proposed. Some positions have been restructured previously and so have enhanced seniority in the debt capital structure. We intend to leverage this position to maximise our ability to repair these positions and to deliver the restoration of value to shareholders. We expect that over the course of the next twelve months, as economic uncertainty diminishes, we will be able to reassess the levels of impairment attributed to these loans but in the meantime, a prudent indicative impairment has been proposed. Over the next two weeks, prior to the announcement of the 30 June 2020 NAV, KKV will undertake further detailed analysis to substantiate individual impairments which will then be recommended to the Board of the Company. In aggregate, impairments are likely to be within a range of £20-24m for the Ordinary Shares and £8-10m for the C Shares. This complies with the Company's obligations under IFRS9 and KKV will endeavour to recover the impact of Covid-19 over the coming twelve months.

Summary of Ordinary Share Additional Impairments

Hospital Investment (US) Carrying value: £9.2m

This facility comprises debt and a nominally larger equity holding resulting from a previous restructure. The borrower has requested deferral of interest payments until October 2020. The Company has not received payment since March 2020 directly due to Covid-19 and the consequential fall in elective surgery in light of operating restrictions at the hospital. We believe that further deterioration in outlook is expected, and that a further restructure is highly likely. The debt portion is secured on equipment for which an up to date valuation is being undertaken.

Solar (US): Carrying value: £23.6m

The outlook for this asset remains uncertain as it requires due legal process to be successful with regard to the parental guarantee pay-out. Furthermore, redress through distribution of tariff payments are subject to negotiation and there are also political considerations which may affect the timing and amount of recovery. There are two leases that are delivering payments, but these are small and insufficient to meet the overall debt liability. We have therefore assigned an additional impairment to the facility. We have also commenced discussions with legal counsel to reduce ongoing legal costs attributable to this loan.

Temporary Accommodation (UK): Carrying value: £6.1m

This loan was restructured previously and is a business linked to the leisure/hospitality sector. The facility finances container crates repurposed as temporary accommodation and used at tourist, festival and exhibition locations. This industry has been particularly hard hit by Covid-19 and the borrower has missed payments since March 2020. However, we consider that an impairment is still appropriate despite considering the latitude provided by forbearance under IFRS 9 guidance as some security is of unclear value.

Retail Boilers – Consumer Loans (*UK): Carrying value: £10.0m*

This consumer loan portfolio has approximately 4,200 individual loans to homeowners with 5% over six months in arrears. Each loan is constructed to include a lien against the property in which the equipment is installed. The credit outlook is reasonable, though our long-term financing rate is not sustainable as the annual payment needs to fully amortise the debt, pay the boiler servicing cost and our interest margin. Therefore, the pool is effectively in wind-down and there is a heightened risk of collections deteriorating as the pool shrinks and the boilers age requiring replacement or increased maintenance.

Hotel Technology (*UK): Carrying value: £11.1m*

The facility is in three tranches and includes administration costs and debts prior to restructure in September 2019. The company provides data and hardware to the hotel and leisure sectors and has been heavily impacted by Covid-19. The original facility financed equipment providing front of house user interfaces. The company has a strong pipeline of orders to high end hotel groups and has a healthy business model. At present, cash flow constraints are heightened by the present economic downturn.

Paper Manufacturer (*UK): Carrying value: £4.0m*

Major paper manufacturer in the UK and this facility was restructured in 2019 following financial difficulties. The recent restructure and settlement of our position has been complicated by Covid-19 and so despite a small balance outstanding from the original loan we consider it prudent to apply an additional impairment.

Telephone Masts *(BR): Carrying value: £4.9m*

The credit outlook for this asset remains uncertain as the business has not been paying for an extended period. The portfolio of assets is a sub scale portfolio (under 100 masts) and the borrower has been reinvesting in new masts at expense of debt servicing with the view that a larger basket of assets is easier to sell. We have requested a revaluation of the whole portfolio and are considering an exit strategy.

Heavy Plant Construction Vehicles *(SL): Carrying value: £1.4m*

This heavy construction vehicle hire business is based overseas. Originally, the facility financed African operations of a UK construction firm that failed and this is the small rump asset taken over by the local manager in Africa operating the fleet to operate and maintain. The loan arrangement allows for pass-through of hire revenue. Given the heavy usage in Africa there is an issue with maintenance capex for the successful delivery of the service. We are currently negotiating sale of the equipment to the operator.

AD Plant *(UK): Carrying value: £2.0m*

This smaller scale AD plant is a joint venture with an infrastructure investment manager, although the investment is stable and the output was 94% utilisation, a fire at the site has impaired production.

Aviation*: Carrying value: £2.3m*

This is a portfolio of five used helicopters; four are leased to a large corporate entity and another is in “hot storage” and awaiting sale. All repayments are utilisation based and so a small impairment to reflect under-utilisation has been applied.

Summary of C Share Additional Impairments

Auto parts manufacturer *(FR): Carrying value: £6.4m*

The facility financed key operational equipment to supply Renault/ PSA with engine parts. However, these parts have proved to be of limited use. There is uncertainty around the ability to recover assets given the domicile and actions are constrained by the French legal system. Debt service has remained unpaid since September 2019. We consider this asset to be distressed but as the auto industry is important to the French government, a strategic buyer being found is a possibility.

Energy *(UK): Carrying value: £3.4m*

This power cell hirer to building sites has an uncertain credit outlook as it had already a history of late payment and has been affected by Covid-19. It is also reliant on one key member of staff to facilitate operations and payments, and they are currently unable to work full-time.

Oil & Gas Pipeline Servicer (NL): Carrying value: £0.6m

Oil & Gas well intervention business whereby the facility financed proprietary pipe unblocking tool. The credit outlook is uncertain on a standalone basis but we take comfort from the support of an Ultra High Net Worth sponsor, not believed to be under stress and who is supportive.

Summary of loans held across Ordinary and C Share Classes

Shipping *(UK): Carrying value: £32.3m*

A fleet of ships owned by experienced operator of typically lower quality within marketplace. This facility is held in four separate tranches across the Ord and C Share Classes. Originally planned as a short-term ownership with exit via sale of assets has developed into a longer-term loan. From a credit perspective, the outlook remains uncertain as the fleet have significant overheads and a depreciation profile unsuited to a forced disposal which would result in a significant loss in a fire sale. Although there is a guarantee from the parent company together with a requirement to contribute to deleverage as the loan to value rises, it is hard to establish the exact nature of our ability to exercise this guarantee given that the company and industry has been impacted by Covid-19.

Remote Operating Vehicles (UK): Carrying value: £20.0m

This company supplies deep sea submarines for surveillance and maintenance purposes. The product is of a high quality however the company has suffered from the reduction in oil prices and dependence on one significant customer. The overall facility comprises of four tranches of loans including a recent restructure that improves our security package, reduces overheads, improves management and injects additional cashflow into the business from two prominent private equity investors. These actions have given the business breathing space to get through the current economic environment.

Maturity Profile

Given the forthcoming continuation vote for both Share Classes on 16 July 2020, the maturity profile of both classes is important to be considered. The following chart shows the run-off repayment profiles of both Share Classes based on contractual terms:

	C Share	Ordinary Share	Total of combined
< 6 months	12%	8%	10%
6-12 months	14%	17%	16%
1-2 years	6%	2%	3%
2-3 years	12%	11%	11%
3-5 years	10%	2%	5%
5-7 years	19%	19%	19%
7-10 years	17%	8%	11%
>10 years	8%	33%	24%

Of note, is the absence of any future operating expenditure requirements of existing borrowers which has been a particularly acute aspect of the Covid-19 pandemic. Given the level of uncertainty in relation to potential funding requirements, our ability to reinstate dividends to Shareholders is constrained at the present time. Only when we can deliver a sustainable dividend over the medium term, will we recommend payment of such dividends to the Board of the Company. It is expected that dividend payments will not be possible at the previous level of 7.25p per Share and a lower, sustainable level of dividend will need to be considered.

With regard to FX exposures, at present the cost of implementing a hedging strategy is prohibitive and we are considering a number of lower costs strategies to resume an appropriate level of cover for the fund.

Conclusion

Continuation of the Company has been structured in two stages. The first vote is to be held on 16 July 2020 and if passed, allows for us to stabilise both the Ordinary Share portfolio and the C Share portfolio over a period of twelve months. In 2021, approximately 12 months following the 2020 vote, a further continuation vote would be proposed where we would ask for a further three years. The vote was designed in this way in order for Shareholders to have an opportunity to observe our performance during this time. No new underwriting is permitted during the next twelve months. This phased approach gives breathing space for the economic background to improve and for KKV to gain shareholder confidence that we are a competent and worthy steward of these assets. To avoid further erosion of value, we are keen to gain your support for continuation in order that we can commence the stabilisation stage of our plan.

With the continuation vote approaching, we have been engaging with Shareholders in order that they are appraised of the risks and the path to stabilisation that we would follow. KKV has a high degree of confidence that we can repair and reinstate valuable income and capital to shareholders over the coming twelve months and ask for your support in the upcoming vote.

This announcement is released by SQN Asset Finance Income Fund Limited and contains inside information for the purposes of Article 7 of the Market Abuse Regulation (EU) 596/2014 (MAR), and is disclosed in accordance with the Company's obligations under Article 17 of MAR.

For further information please contact:

KKV Investment Management Ltd 020 7429 2200

Catherine Halford Riera

Nicola Bird

For the purposes of MAR and Article 2 of Commission Implementing Regulation (EU) 2016/1055, the person responsible for releasing this announcement is Peter Niven, Chairman.