Permanent and Private Capital in the Time of COVID-19

Where We've Been and Where We're Going

Dechert LLP

ING

KBW Keefe, Bruyette & Woods
A Stifel Company

Contents

Introduction

In the summer of 2020, approximately 450 fund sponsors and asset managers gathered virtually for **"Permanent and Private Capital in the Time of COVID: Where We've Been and Where We're Going"** sponsored by **Dechert LLP, ING** and **KBW/Stifel**. Tapping into the experience of leading industry institutions, our guest speakers shared their thoughts on the current state of the market and the impact of the COVID-19 pandemic, focusing on mergers and acquisitions, fund leverage and capital markets.

These sorts of issues, managing that transition, is going to be immensely challenging and could be a factor that perhaps makes getting back to the previous peak level of economic output a little bit more difficult.

VIEW JAMES KNIGHTLEY'S STATE OF THE MARKET

State of the Market

James Knightley, Chief International Economist, ING

The COVID-19 situation has not only been a huge health crisis, but an economic one as well. For example, the U.S. economy as a whole, by the summer of 2020, had contracted 10 percent since the crisis started. Now as the country re-opens while COVID-19 infection rates rise, consumers and employers alike remain skeptical of a safe and sustained economic recovery.

Income growth is another factor that has given some economists pause. "One of the big positive boosts to the recovery story has been the Federal Government's extra $600 a week payment in addition to States' Unemployment Benefits," said ING chief economist James Knightley. The payment was designed to help 30 million people who have lost their jobs during the pandemic. President Trump announced an end to that program and will be replaced by a $400 payment per week program, but the states will have to subsidize it and many can't afford to do so. "I think there is a real risk that we see that $600 payment drop to $300 payment and that is an income squeeze for tens of millions of households," said Knightley.

The upcoming presidential election is yet another factor that may create significant economic uncertainty as well. Will the U.S. have a new president come November and, if so, what will a Joe Biden presidency look like? Corporations would likely have to pay more taxes, but there would also be more opportunities for investments in green energy and big infrastructure projects. In the event that many states lock down again due to COVID-19, that may affect the economic outlook for several industries, including travel and hospitality, retail and real estate among others. "These sorts of issues, managing that transition, is going to be immensely challenging and could be a factor that perhaps makes getting back to the previous peak level of economic output a little bit more difficult," said Knightley.

Asset Management M&A:

Themes and Strategies for 2020

COVID-19 has established itself as a market disruptor. Mergers and acquisitions activity contracted rapidly at the outset of the pandemic but have since rebounded. Moderated by Dechert partner, Ken Young, several themes emerged from the M&A discussion: that COVID would likely increase consolidation among asset managers, accelerating an already existing trend; that the acquisition of platforms for diversification and of pools of assets for scale are both strategies that will remain relevant; and that these trends are not going away any time soon.

Richard Byrne, President, Benefit Street Partners
Ted Goldthorpe, Partner, Head of BC Partners Credit, BC Partners
Al Laufenberg, Managing Director, KBW/Stifel
Nicole Macarchuk, Chief Operating Officer, General Counsel and Managing Director, Angel Island Capital
Mehdi Mahmud, President and Chief Executive Officer, First Eagle Investment Management
Ken Young, Partner, Dechert LLP (Moderator)

The panel discussed strategies driving the acquisition of platforms and explained that when it comes to expanding capabilities through these acquisitions, organizations continue to focus on areas that are difficult to enter organically. When discussing certain real estate platform acquisitions for example, Richard Byrne of Benefit Street Partners summarized the point by saying "if we already knew how to do it, we wouldn't have bought them."

For some managers, acquisitions help a manager expand into a new asset class – like credit or real estate, and for others, acquisitions are about diversifying the channels the manager accesses, mostly by moving into more retail channels. During the discussion of acquisition strategies, Mehdi Mahmud explained that most of First Eagle's business consists of retail customers and there is an expectation that those investors will require increased supplemental income in coming years; as a result, it was important to First Eagle to expand into alternative assets such as private credit. Mahmud noted, however, that there are some "barriers to entry in private credit" and as a result, he explained that "the objective of our last couple of transactions was to acquire investment capabilities that we didn't have and to do so over a shorter period of time than we could have built organically."

The panelists also discussed getting deals done during COVID and how this new environment has shown how important it is to get to know the teams of platforms. Describing his experiences in the current environment, Al Laufenberg of KBW/Stifel explained "that the 'known' factor really matters in this new world." However, the current, largely remote, work environment makes it harder to build new relationships which means existing relationships can be an important driver in facilitating transactions. Familiarity between parties can help increase the speed and certainty in executing a deal, which is important as COVID has turned more parties to focus on deal certainty when pursuing a transaction. Ted Goldthorpe of BC Partners explained that now more than ever, "anyone who is selling a business is incredibly focused on certainty of execution and making sure the deal can get done."

The panel talked about scale-driven acquisitions, focusing on which targets make a good fit and the challenge of valuation given the market uncertainty brought about by COVID. Panelists talked about how important it is to get valuation right, or else the synergies expected in these deals might not materialize. When discussing valuations, Nicole Macarchuk of Angel Island Capital talked about how the same assets across multiple platforms, particularly BDCs, can be valued differently based on the specific manager's policies and procedures. Given the variation in valuations, Macarchuk noted that "when it comes to M&A, it is extremely important to do your due diligence" but also noted that it is important to look at all valuations as a group rather than focusing on the valuation methodology for a single asset.

In wrapping up the panel's diverse discussion, Young noted that the panel members focused on "similar and interesting things, which is that we are in weird times, they are difficult times and they are highlighting cracks and themes that we have been seeing for years and that are going to continue to accelerate."

VIEW THIS PANEL

> "
>
> *... anyone who is selling a business is incredibly focused on certainty of execution and making sure the deal can get done.*

Fund Leverage in the Time of COVID

Prior to the recent COVID-related turmoil in the global economy, fund managers in the private credit space had been taking increasing advantage of the growth of a wide range of fund leverage products and strategies, including fund-level asset-based facilities, "drop-down" special purpose structures, and unsecured financing products.

Noting that each of these financing products has now been stress-tested by the pandemic and its effect on virtually all economic sectors (creating challenges, but also providing a "lifeline and a source of new capital" to managers in a period of crisis), moderator Jay Alicandri of Dechert LLP invited the panelists to reflect on the continuing importance of these financing strategies for managers in navigating the current environment, and to look ahead to the future. While clear-eyed as to the continued uncertainty facing the industry, the panelists ultimately provided a cautious, but optimistic, outlook.

The panelists were in agreement that maintaining a diversified fund leverage strategy provides important flexibility in the face of challenging market conditions, with Alan Kirshenbaum of Owl Rock noting that "diversifying the right side of the balance sheet is just as important as diversifying the left side of the balance sheet".

Particularly in an environment where there is widespread downward pressure on valuations throughout the economy that can weigh on the borrowing base and equity cushions in secured facilities, several of the panelists noted the advantages of having unsecured debt that is easy to manage and that leaves unencumbered assets available to overcollateralize secured facilities. But while some managers have faced challenges in the recent environment managing to financial covenants in secured facilities, the participants were in agreement as to the continuing value of secured debt as an important component of fund leverage strategies as well, with Steve Kuppenheimer of GSO noting that fund-level revolvers remain the "most-chased" product for their flexibility and

"diversifying the right side of the balance sheet is just as important as diversifying the left side of the balance sheet."

Patrick Frisch, Managing Director, Head of Americas Fund Finance, ING
Alan Kirshenbaum, Chief Operating Officer and Chief Financial Officer, Owl Rock Capital
Stephan Kuppenheimer, Senior Managing Director, GSO Capital Partners
Jason Young, Deputy General Counsel, Legal & Finance, FS Investments
Jay Alicandri, Partner, Dechert LLP (Moderator)

pricing. Jason Young of FS Investments noted that a key factor for managers in evaluating both fund-level and drop-down SPV secured products is maintaining sufficient rights in determining the value of underlying assets, noting that "fewer instances of revaluation and having external checks on valuation makes it much easier to manage these leverage facilities through periods of economic distress".

From the lender perspective, Patrick Frisch of ING noted that while "essentially nothing was spared" from the effects of the pandemic, and that many borrowers have had the need to discuss financial covenant or borrowing base relief, an extensive analysis of the recent data shows resilience in the industry, with comparatively small changes to overall borrowing base usage and erosion of equity cushions since before the pandemic. Frisch also highlighted the challenges for lenders in navigating disassociation between short-term price volatility in the liquid market relative to long-term asset quality, noting the importance of the latter as they "are not looking to liquidate our clients' portfolios during a crisis." The participants were in agreement as to the continuing importance of relationships between managers and lenders in periods of stress, with Jason Young noting that "ultimately, a lot of this comes down to having a good partner in your lender."

The panel closed on a note of cautious optimism for the future. Patrick Frisch highlighted data showing that the increase in borrowing base usage since the pandemic has been concentrated among borrowers who entered the pandemic with larger borrowing base and equity cushions, suggesting that participants with stronger balance sheets are taking advantage of opportunities that continue to exist in the market. Both Alan Kirshenbaum and Jason Young noted that the full spectrum of financing products has continued to be available to well-capitalized funds throughout the pandemic. And as Steve Kuppenheimer observed, "this crisis has been largely confirmatory of the BDC industry," noting that the questions in recent years as to how the industry would respond in a true crisis have now been answered, with the industry showing itself to be resilient and robust.

> *"fewer instances of revaluation and having external checks on valuation makes it much easier to manage these leverage facilities through periods of economic distress."*

VIEW THIS PANEL

BDC and Private Credit Fund Industry Roundup:

Investing and Capital Markets Activity and Trends in an Uncertain Environment

Fears related to the COVID-19 coronavirus sent immediate shockwaves through the capital markets in the spring of 2020, with major sell offs of stocks of BDCs and other funds focused on private credit. Although the capital markets were effectively closed for several months thereafter, BDCs and private credit funds have since been able to tap the capital markets to help shore up their balance sheets and arrest concerns about potential liquidity issues, including their ability to fund existing financing commitments.

The panelists took a broad approach to tackling this topic by first exploring the "brave new world" of investing for BDCs and other private debt funds during the pandemic, as well as how private credit managers have modified their investment activities and the ways in which they analyze and price credit risk. Most interestingly, while panelists described a cautious investing approach to companies that have been materially negatively impacted by social distancing measures, shelter-in-place/stay-at-home orders and the related supply chain disruptions (the so-called "red zone" companies), they also emphasized the robust nature of competition among lenders for the limited number of new, non-red-zone investment opportunities, including from CLOs going "down-market" in search deals.

Eric Lloyd, Global Head of Private Investments and Managing Director, Barings LLC and Chief Executive Officer, Barings BDC, Inc.

Michael Mauer, Co-Head, Investcorp Credit Management US LLC and Chairman and Chief Executive Officer, Investcorp Credit Management BDC, Inc.

Penni Roll, Partner and Chief Financial Officer, Ares Credit Group and Chief Financial Officer, Ares Capital Corporation

Ian Simmonds, Managing Director, Sixth Street and Chief Financial Officer, Sixth Street Specialty Lending, Inc.

Harry Pangas, Partner, Dechert LLP (Moderator)

150%

The panelists reiterated a number of times the fact that BDCs have a large number of tools and levers available to them to manage through economic and other crises, including to opt into the 150% asset coverage requirement, and conduct rights offerings and obtain approval to issue shares below net asset value.

Next, the panelists discussed the balance sheet and liquidity risk management lessons for BDCs and other private credit funds that the COVID-19 pandemic has reinforced. These lessons include obtaining diverse forms of committed capital from a variety of sources that provide for liquidity beyond current balance sheet needs, as well as the value of having a mix of unsecured and secured debt given that a greater allocation to unsecured debt means greater collateral coverage and ability to borrow under secured lines of credit during times of stress. The panelists reiterated a number of times the fact that BDCs have a large number of tools and levers available to them to manage through economic and other crises, including to opt into the 150% asset coverage requirement, and conduct rights offerings and obtain approval to issue shares below net asset value. One panelist even sounded out a call for regulatory reform with respect to the below net asset value approval voting standard given the disenfranchisement of an otherwise unaffiliated greater than 5% stockholder of a BDC in connection with the vote.

The conversation then turned to current trends in the capital markets as well as potential regulatory developments that may impact future capital raising efforts by BDCs and private credit funds. The panelists kicked off the discussion by highlighting that BDCs and private credit funds have a myriad of financing options available to them today that they did not have ten or so years ago, including financing options like retail “baby” bonds, institutional high-grade debt, convertible debt, CLO technology, ATMs and more. The consensus view among the panelists was that this change has been driven by the increased “comfort” of investors and rating agencies with BDCs specifically and private lending more generally.

The result is that 13 BDCs now have investment grade credit ratings and, as a result, access to the institutional investment grade debt market and better access to the convertible debt market. After surveying the capital markets transaction landscape for BDCs and other private credit funds in the immediate aftermath of the COVD-19 lockdowns and more recently, the panelists then touched upon various proposed regulatory actions, including relating to the Acquired Fund Fees and Expenses rule and Form 13-F, and how these potential regulatory initiatives may impact capital raising efforts for BDCs on a go-forward basis.

The panel concluded with each panelist making predictions for the BDC and private credit space over the next 12 to 18 months.

VIEW THIS PANEL

Views from our Audience

How long will it be before the economy/deal is back to pre-COVID levels?

1% By the end of '20

57% Sometime in '21

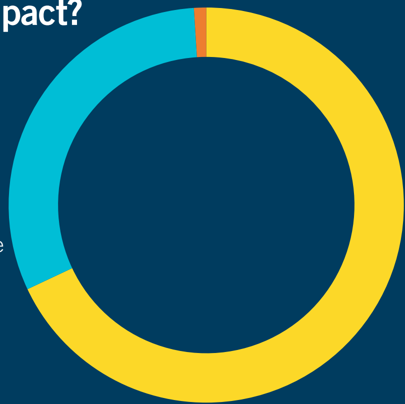
42% In '22 or later

On which part of the upcoming U.S. elections are you most focused, in terms of economic impact?

68% Presidential

31% Control of U.S. Senate

1% State and local



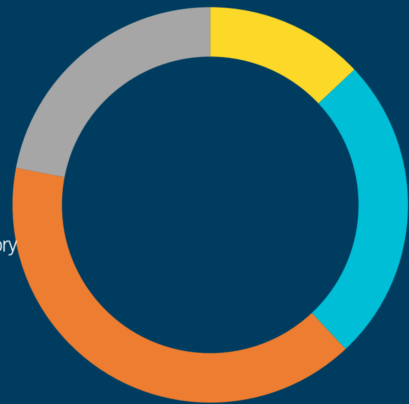
What is your biggest concern over the next two to three years?

13% Higher inflation

25% Enhanced regulatory environment

40% Social unrest

22% Higher taxes

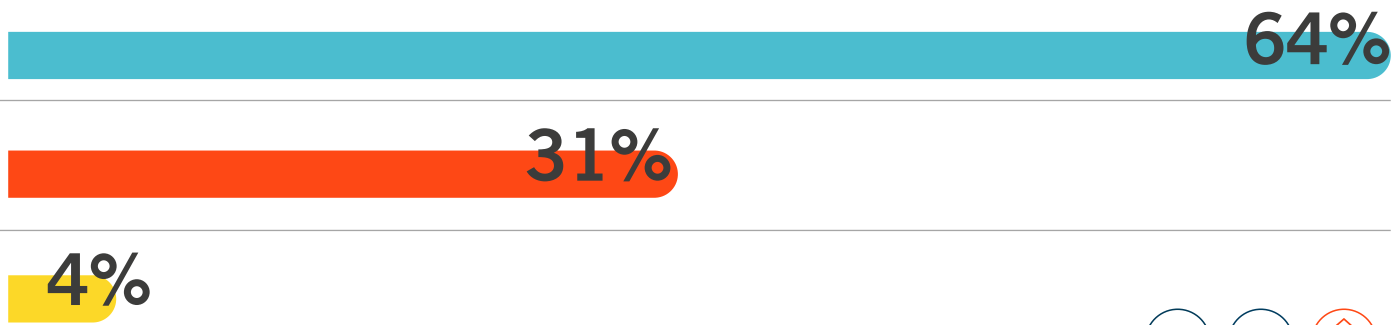


Which of the following best describes your views on alternative asset management platform scale following the pandemic?

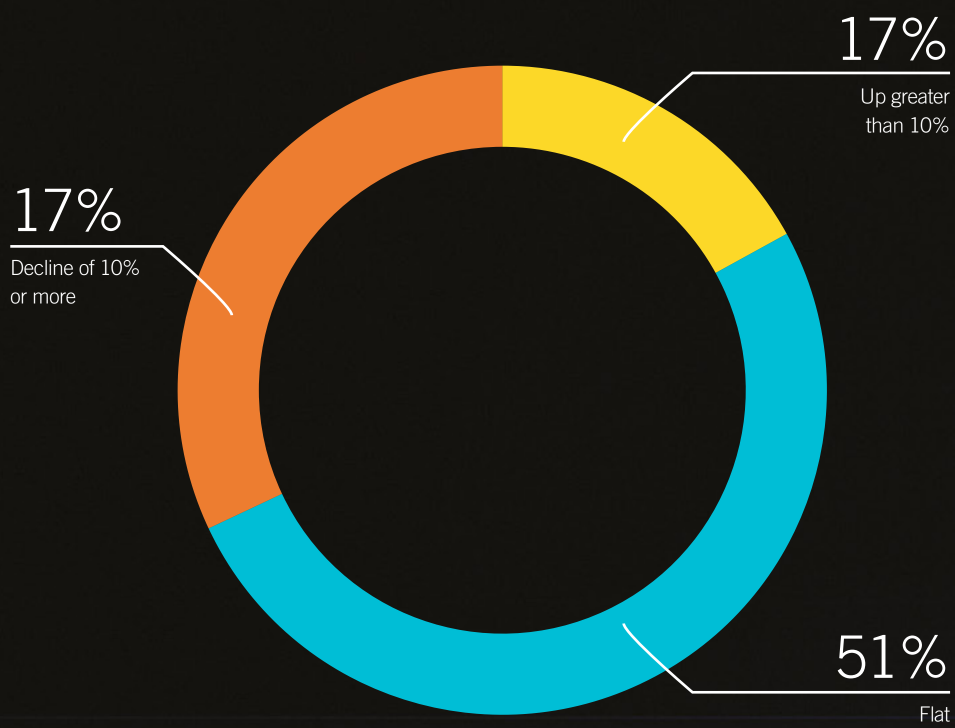
Large scale matters more than ever

Niche lending / investing opportunities will become more plentiful

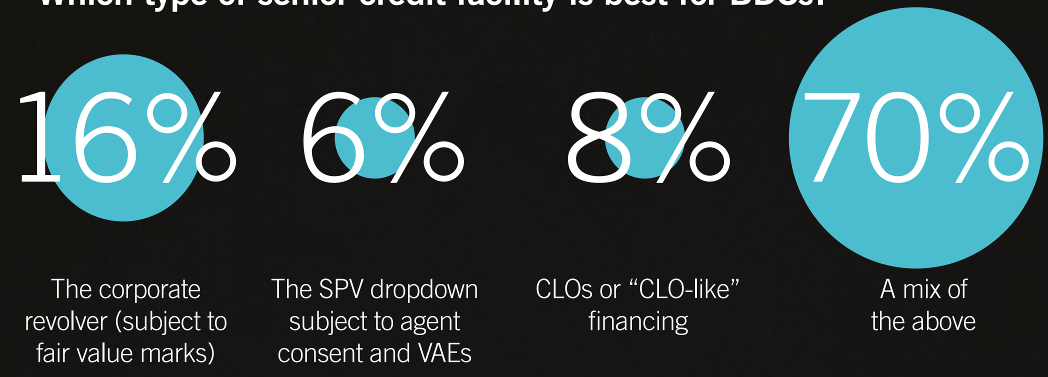
New start-up alternative asset management more likely



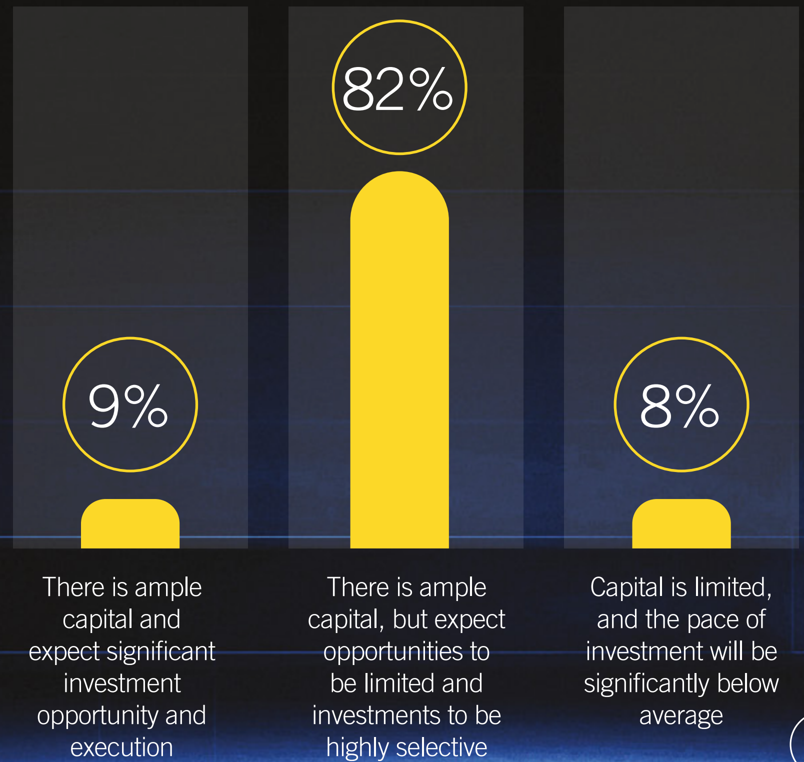
Overall stock market returns over the next 12 months.



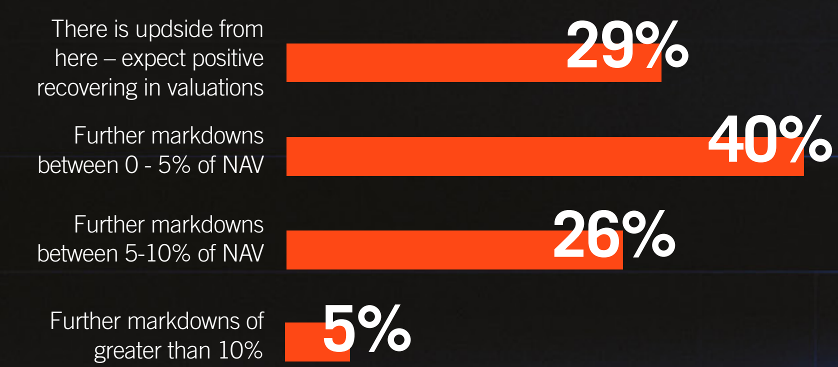
Which type of senior credit facility is best for BDCs?



What do you think best describes the tone of private lending activity in the 2nd half of 2020.



What do you think will be the impact from COVID-19 on private credit portfolios for the rest of 2020?



The Sponsors

Dechert LLP

Dechert's multidisciplinary permanent and private capital team is actively engaged in advising asset managers in all aspects of their capital strategies. Our lawyers possess a detailed understanding of current trends and developments, up-to-the-minute market terms and an insider's perspective when it comes to regulatory compliance. We are committed to turning our experience and expertise into value for our clients.

ING

ING is a financial services firm offering a full array of wholesale lending, treasury products and advisory services to corporate and institutional clients. ING Capital LLC is headquartered in New York City, and is a subsidiary of ING Bank NV, part of ING Group.

KBW Keefe, Bruyette & Woods

A Stifel Company

Keefe, Bruyette & Woods (KBW) is a full-service, boutique investment bank and broker-dealer that specializes in the financial services sector. We operate in North America and Europe, providing institutional & private investors and financial services companies with research, equity sales & trading, capital raising, and strategic advisory services. We have built our reputation for excellence in financial services on the basis of our research platform, our senior professionals, track record of market innovation, and the strength of our execution capabilities.

Thank you for reading