MOODY'S
INVESTORS SERVICE

Credit Opinion: Investcorp Bank B.S.C.

Global Credit Research - 29 Jan 2014

Manama, Bahrain - Off Shore

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Ba2/NP
Bank Financial Strength	D
Baseline Credit Assessment	ba2
Adjusted Baseline Credit Assessment	ba2
Investcorp Capital Limited	
Outlook	Stable
Bkd Senior Unsecured	Ba2
Investcorp S.A.	
Outlook	Stable
Bkd Senior Unsecured	Ba2

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Key Indicators

Investcorp Bank B.S.C.

	[1]2013	[1]2012	[1]2011	[1]2010	[1]2009	[1]2008	[2]CARG/Average
Assets Under Management ($ million)	10,496.0	11,490.0	11,835.0	12,654.0	11,734.0	17,680.0	-9.9
Revenue ($ million)	361.8	267.1	413.6	360.7	(437.1)	582.4	-9.1
EBITDA ($ million) [3][4]	180.9	122.4	205.3	179.5	(636.2)	323.1	-11.0
Net Income ($ million) [4]	65.7	26.8	99.7	73.3	(780.6)	151.1	-15.3
Debt ($ million) [5]	1,228.2	1,466.2	1,512.6	2,185.9	2,490.1	2,088.3	-10.1
Tangible Common Equity ($ million) [5]	742.0	694.9	681.4	649.8	604.8	1,239.7	-9.8
Net Cash Capital ($ million) [6]	478.4	(245.8)	101.9	548.3	662.1	(463.8)	--
Financial Leverage: Debt / EBITDA (x) [5]	6.8	12.0	7.4	12.2	(3.9)	6.5	6.8
Self-managed investments/ Shareholders' equity (x) [5][7]	1.9	2.5	2.7	2.5	2.9	2.7	2.5
Net Cash Capital / Liquid Net Assets (%) [6]	51.3	(32.4)	13.2	40.7	41.8	(39.5)	12.5
Illiquid Risk Positions / Tangible Common Equity (x) [5][8]	2.0	2.8	3.0	3.1	3.2	2.8	2.8
Net Income Margin (%) [4]	18.2	10.0	24.1	20.3	178.6	25.9	46.2

[1] Fiscal Year Ends June 30th. [2] Composite reflects 5-year (2008-2013) growth rates (CAGR) or averages. [3] EBITDA = Net income + Interest + Taxes + Depreciation and Amortization. [4] We adjust net income by including the dividend paid on the debt component of preference shares (see equity adjustment below). [5] We adjust equity by capping the amount of preference shares included to a maximum of 25% of equity, with the rest regarded as a debt component. [6] Net cash capital is the surplus of a firm's sources of long-term capital (principally common

equity and long-term debt) beyond its uses of long-term capital (principally illiquid asset and haircuts on securities inventory). [7] Self Managed Investments / Equity is the ratio of a firm's on balance sheet investments managed by the firm's own portfolio managers, relative to the firm's total shareholders' equity. [8] Illiquid risk assets comprise balance sheet loans and co-investments in private equity, hedge funds and real estate.

Opinion

SUMMARY RATING RATIONALE

The Ba2 deposit rating, assigned to Investcorp Bank B.S.C. (Investcorp) reflects its ba2 baseline credit assessment (BCA), equivalent to a D standalone bank financial strength rating (BFSR). The ratings are supported by Investcorp's (1) solid position as a Gulf Cooperation Council (GCC) based provider of international alternative investments; and (2) good liquidity and improved funding profile. We have recently changed the outlook on the ratings to stable, from negative, to capture Investcorp's balance sheet deleveraging, its reduced on-balance sheet risk and the ongoing recovery in its fee revenue.

However, the rating remain constrained by the limited global scale of Investcorp's operations and risks inherent in its business model, including (1) fairly high, albeit declining, balance sheet exposure to private equity investments (with corporate and real estate investments accounting for around 140% of Moody's adjusted tangible common equity as at June 2013); and (2) an inherently volatile earnings profile.

Rating Drivers

- A smaller investment portfolio as a percentage of equity, affords the company greater flexibility to withstand adverse market developments

- Persistent risks posed by fairly high exposures to private equity investments, although these exposures are declining

- The company benefits from good liquidity and an improved funding profile

- Despite Investcorp's limited global scale, the company benefits from a strong niche market position in the GCC

- Investcorp's fee revenue is gradually recovering, but its earnings profile remains inherently volatile

Rating Outlook

All ratings carry a stable outlook.

What Could Change the Rating - Up

Upward pressure could be exerted on Investcorp's ratings by the successful and sustained execution of the company's plan to (1) further reduce its self-managed fund portfolio (by reducing its hedge fund holdings, disposing of its mature private equity portfolio investments and restricting the funds to be invested in future acquisitions); and (2) increase the volume of client assets under management.

What Could Change the Rating - Down

Negative rating pressure could result from a weaker financial position driven by (1) lower private equity origination and placement activities that would constrain Investcorp's profitability; (2) material investment losses; (3) an erosion in the company's improving capital base; or (4) a reversal of the trend of both decreasing debt and on-balance sheet investment levels.

DETAILED RATING CONSIDERATIONS

A SMALLER INVESTMENT PORTFOLIO AS A PERCENTAGE OF EQUITY, AFFORDS THE COMPANY GREATER FLEXIBILITY TO WITHSTAND ADVERSE MARKET DEVELOPMENTS

Investcorp's improving capital levels as a proportion of its on-balance sheet investments and loans (illiquid risk assets) is a prime driver of its credit strength. In particular, its illiquid risk assets-to-Moody's-adjusted tangible common equity ratio stood at 2.0x as at end-June 2013, an improvement from 3.0x as at end-June 2011. We adjust equity by capping the amount of preference shares included to a maximum of 25% of shareholder equity

($185 million as of June 2013), with the rest ($327 million) regarded as a hybrid debt component (excluding our adjustment, the illiquid risk assets-to-tangible common equity ratio would be around 1.4x).

We view the illiquid risk assets-to-tangible common equity ratio as a more appropriate measure of Investcorp's capitalisation and financial flexibility than either (1) the otherwise strong pro-forma regulatory capital adequacy ratio of 24.6% at end-September 2013; or (2) the otherwise weak financial leverage (total Moody's adjusted debt-to-EBITDA) ratio of 6.0x during the fiscal year ended June 2013 (FYE2013).

Nonetheless, we monitor both the financial leverage and earnings coverage as a second perspective, and normalise EBITDA by (1) replacing asset-based income with a 5% return on fiscal year-end balance sheet investments; and (2) replacing the fiscal year's performance fees with a five-year performance fee average discounted by 25%.

A successful execution of the company's plan to further reduce its on-balance sheet illiquid risk assets will support the company's credit risk profile. Over the next two fiscal years (i.e., by FYE June 2015), the company is projecting a further decline in the illiquid risk assets-to-tangible common equity ratio as a result of a reduction in its hedge fund holdings, the disposal of its mature private equity portfolio investments and restricting the funds to be invested in future acquisition. However, we expect the company to continue to face implementation risks related to the disposal of private equity investments, under prevailing market conditions.

We view the company's recent re-purchase of $106 million preference shares (around 20% of total) as neutral to its credit profile. While actions have reduced its shareholder equity, we note that as a consequence of our cap, the re-purchase will have no impact on the way we calculate our own capital ratios. The re-purchase of preference shares has also reduced the currently high discretionary preference share dividend of $61.4 million, which has been limiting the company's internal capital generation through retained earnings.

PERSISTENT RISKS POSED BY FAIRLY HIGH EXPOSURES TO PRIVATE EQUITY INVESTMENTS, ALTHOUGH THESE EXPOSURES ARE DECLINING

Our overall capital assessment also takes into account the company's intrinsically high risk appetite and private equity book concentration risk. Although on-balance sheet private equity investments have been declining, these remain high with corporate and real estate investments accounting for around 140% of Moody's-adjusted tangible common equity as at June 2013 (from around 200% as at June 2009). We note the company's active management of portfolio companies (through cost-cutting measures and add-on acquisitions), which may help limit negative valuation adjustments; however, Investcorp's capital base remains vulnerable to a deterioration in the financial position of any of its large investments. Risks are currently accentuated by potential volatility in valuations given the high risks in the operating environments where these companies operate, particularly for those in Europe. We note positively that the company has reduced its investment concentrations, with only one corporate investment exceeding 10% of shareholder equity as of June 2013 (according to company disclosures).

GOOD LIQUIDITY AND IMPROVED FUNDING PROFILE

The ratings are also supported by the company's improved funding profile. Since 2009, the company has embarked on deleveraging its balance sheet, with a reduction in its market funding reliance as Moody's-adjusted debt dropped to $1.2 billion as at June 2013, from $2.5 billion as at June 2009. We also note the successful refinancing of its syndicated bank loans and a debut bond issuance. The debut $250 million 8.25% five-year bond was issued in November 2012, and has lengthened and diversified its funding base and increased its contingency liquidity facilities through committed bank lines, which will likely remain undrawn.

The company also has a good liquidity profile and it displays good liquidity management practices, with only moderate maturities over the next two fiscal years. The company has cash and interbank balances of $450 million (as of September 2013, net of $343 million deployed during Q1 FYE 2014), which cover the debt amounting to $326 million maturing by June 2017, although we note that the company has utilised $106 million to re-purchase around 20% of its preference shares. At the same time, the company's co-underwriting arrangement reduces on-balance sheet liquidity requirements, whereby a portion of private equity deals are jointly underwritten by third-party investors without recourse to the company. As part of the company's contingency planning, we also note around $135 million in hedge funds, which we believe can be used to generate liquidity in case of stress (out of a total of around $335 million as of September 2013).

As part of our liquidity assessment, we compare the company's net cash capital to its liquid net assets. The company's net cash capital is the surplus of a firm's sources of long-term capital (principally common equity and long-term debt) beyond its uses of long-term capital (principally illiquid asset and haircuts on securities inventory).

We believe a firm should have an absolute cash capital surplus because a deficit means that a firm could be forced to liquidate assets or portions of its business if it is unable to rollover its short-term financing. Investcorp had a material net cash capital surplus, with a net cash capital-to-liquid net assets ratio at 51% as at end-June 2013.

A STRONG NICHE MARKET POSITION IN THE GCC, DESPITE LIMITED GLOBAL SCALE

Investcorp has a limited scale and global franchise position. With cumulative assets under management of $10.8 billion as at September 2013, the company has a limited market share (well below 1%) of global alternative assets under management.

Nevertheless, we believe that the company's credit profile is supported by its strong niche market position in the GCC as an Arab-based provider of international alternative investments. We expect that Investcorp's niche market position will continue to benefit from (1) a strong reputation and recognisable brand name in the GCC, which is a consequence of its robust 30-year track record; (2) its long-standing customer relationships with high-net-worth individuals and institutional investors in the GCC; (3) a good reputation in adding value to its portfolio companies through active management that supports its competitive position in acquiring deals; and (4) the benign operating conditions in the GCC, with a continued accumulation of wealth by GCC institutions and high-net-worth institutions. Investcorp has consolidated its regional market position over recent years as a consequence of weaknesses in some regional competitors and the company's own ability to realise and return profitable investments to its clients.

Whilst Investcorp also attracts institutional hedge fund investors in the US, we believe that the sustainability of the company's franchise position in hedge funds (accounting for 44% of client asset under management and $3.8 billion as at September 2013) is dependent on the company maintaining a strong track record of hedge fund performance, and it will likely remain vulnerable to swings in investment preference. We note that challenging operating conditions have led to moderate performance in the hedge fund industry over the past three years, while many insurance companies have divested from hedge funds in anticipation of the more stringent regulatory requirements under Solvency II.

Investcorp's franchise strength is constrained by its reliance on its core function as an investment manager, with no auxiliary services offered in order to diversify revenues and earnings. In our view, this constraint is partly mitigated by the company's relatively broad product range among alternative investments (private equity, real estate and hedge funds), its wide geographical coverage (spanning the US, Europe, the Middle East and Turkey) and good customer granularity, compared with its regional competitors. Investcorp also has a broader coverage of the GCC region, compared with that of its peers, with a team of dedicated relationship managers, operating through a regional office in Bahrain, but also local offices in Saudi Arabia and Abu Dhabi.

INVESTCORP'S FEE REVENUE IS GRADUALLY RECOVERING, BUT ITS EARNINGS PROFILE REMAINS INHERENTLY VOLATILE

The company's gross revenue can be broken down into three components (1) management fees; (2) deal fees and performance fees; and (3) asset-based income. Management fees are based on the amount of assets under management and have been the most stable source of income (of around $90 million) over the past three fiscal years, albeit negatively affected by the reduction in higher-yielding assets under management, in particular hedge funds.

Under favourable market conditions, Investcorp could also target activity and performance fees of around $200 million (FYE 2013: $241 million, FYE2012: $139 million). This income component is less predictable and depends on acquisition and placement of new investments, the sale and exit of investments (realisations), and the performance of existing investments. Asset-based income is the most volatile profitability component as it is based on the annual return on Investcorp's $1.9 billion proprietary investments (as of September 2013). The average investment yield on its balance sheet investments has been between 0.3% and 4.9% over the past three fiscal years.

For the fiscal year ended June 2013, profitability was supported by strong investment flows (both the acquisition and placement of new investments and the disposal of existing investments) that has led to a pick-up in activity and performance fees. As a consequence, net income during FYE 2013 was $104.9 million, a 56% increase from FYE 2012. We expect current levels of placement and exit activity to continue to support profitability. In contrast, asset-based income was broadly stable amid flat returns on corporate and real estate investments and moderate, albeit improving, hedge fund returns. While Investcorp's balance sheet deleveraging will lead to some reduction in earnings volatility going forward, the company's earnings profile remains inherently volatile.

The company continues to rely on less predictable sources of income (activity and performance fees and asset based income) as reflected in around $190 million of average operating expenses over the past five fiscal years, around $60 million in interest expenses during FYE 2013, and an additional discretionary preference share dividend of around $49 million (from $61 million prior to the preference share re-purchase). This reliance is partly mitigated by Investcorp's remuneration structure as staff expenses decline in weaker-performing years (given that a considerable proportion of staff remuneration is based on the level of profits earned), which supports efficiency metrics in a downturn and enhances its franchise resilience.

The company's net income margin (net income divided as a proportion of gross revenue) was 18.2% during FYE 2013 which is broadly in line with the regional average for the past four fiscal years. This calculation takes into account our standard adjustment on the company's preference shares.

SOURCE OF FACTS AND FIGURES CITED IN THIS REPORT

Unless noted otherwise, data related to system-wide trends is sourced from the Central Bank of Bahrain and providers of alternative asset management industry data (Towers Watson, BarclayHedge, Private Equity International, Preqin). Bank-specific figures originate from Investcorp's annual reports, bond prospectuses and Moody's Banking Financial Metrics.

FINAL RATING VERSUS SCORECARD RESULT

Given Investcorp's wholesale banking license in Bahrain, we use the Moody's Consolidated Global Bank Rating Methodology, published in May 2013 as the primary methodology. However, we also use the "Moody's Global Rating Methodology for Asset Management Firms" (published October 2007) as a secondary methodology to capture certain aspects of its private equity and fund management business profile. As a point of reference, the bank rating methodology's scorecard has a baa3/ba1 outcome, while the overall asset management firm's scorecard outcome is Ba3.

Foreign Currency Deposit Rating

We assign a global foreign currency deposit rating of Ba2/Not-Prime to Investcorp. Investcorp's deposit rating reflects the company's ba2 BCA and does not benefit from any ratings uplift as a result of external support because, despite its prominence as a provider of alternative investments in the GCC, Investcorp (like other Bahraini-registered banks with a wholesale banking licence) is not part of the domestic retail banking system.

Foreign Currency Debt Rating

We assign Ba2 backed senior unsecured debt ratings to the company's wholly owned subsidiaries Investcorp Capital Limited and Investcorp S.A., supported by an explicit guarantee from Investcorp Bank B.S.C. Investcorp S.A., which is registered as an exempted company in the Cayman Islands, is the principal operating arm of the group and owns most of the group's assets. Based in the Cayman Islands, Investcorp Capital Limited was specifically established to issue long-term debt for the Investcorp group.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's standalone Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. Bank Financial Strength Ratings do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of Bank Financial Strength Ratings include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although Bank Financial Strength Ratings exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Moody's uses the standalone Baseline Credit Assessment (BCA) to map BFSRs onto the 21-point aaa-c rating scale and like the BFSR, it reflects a bank stand- alone default risk. Each point on the aaa-c scale represents a specific probability of default and therefore allows Moody's to use the BCA as an input to Moody's Joint Default Analysis (JDA), described below. The baseline credit assessment reflects what the local currency deposit rating of the bank with the given BFSR would be without any assumed external support from a government or third party

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the Bank Financial Strength Rating as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, Moody's Bank Deposit Ratings are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, and includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly. According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of any external elements of support into the bank's Baseline Credit Assessment. In assigning the local currency deposit rating to a bank, the JDA methodology also factors in the rating of the various potential support providers (parent company, cooperative group, regional or national governments), as well as the degree of dependence that may exist between each one of them and the bank. Moody's assessment of the probability of systemic support (by a national government) is derived from the analysis of the capacity of a government and its central bank to provide support on a system-wide basis. The systemic support indicator is determined for a particular country and serves as an input for all bank ratings in that country. The support indicator can be set at, above or, in rare cases, below the government's local currency bond rating for that country.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's bank financial strength scorecard

Moody's bank financial strength model is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Investcorp Bank B.S.C.

Rating Factors [1]	**A**	**B**	**C**	**D**	**E**	**Total Score**	**Trend**
Qualitative Factors (70%)						**D+**	
Factor: Franchise Value						**D**	**Neutral**
Market share and sustainability			**x**				
Geographical diversification			**x**				
Earnings stability					**x**		

Earnings Diversification [2]					x		
Factor: Risk Positioning						D	Neutral
Corporate Governance [2]				x			
- Ownership and Organizational Complexity				x			
- Key Man Risk							
- Insider and Related-Party Risks							
Controls and Risk Management				x			
- Risk Management				x			
- Controls			x				
Financial Reporting Transparency		x					
- Global Comparability	x						
- Frequency and Timeliness			x				
- Quality of Financial Information		x					
Credit Risk Concentration					x		
- Borrower Concentration					x		
- Industry Concentration			x				
Liquidity Management		x					
Market Risk Appetite					x		
Factor: Operating Environment						D	
Economic Stability				x			
Integrity and Corruption				x			
Legal System				x			
Financial Factors (30%)						C-	
Factor: Profitability						D	Neutral
PPI % Average RWA (Basel II)				0.72%			
Net Income % Average RWA (Basel II)				0.69%			
Factor: Liquidity						C-	Neutral
(Market Funds - Liquid Assets) % Total Assets					37.59%		
Liquidity Management		x					
Factor: Capital Adequacy						A	Neutral
Tier 1 Ratio (%) (Basel II)	25.17%						
Tangible Common Equity % RWA (Basel II)	20.07%						
Factor: Efficiency						D	Neutral
Cost / Income Ratio				73.75%			
Factor: Asset Quality						C	Neutral
Problem Loans % Gross Loans					24.95%		
Problem Loans % (Equity + LLR)	7.92%						
Lowest Combined Financial Factor Score (9%)						D	
Economic Insolvency Override						Neutral	
Aggregate BFSR Score						D+	
Aggregate BCA Score						baa3/ba1	
Assigned BFSR						D	
Assigned BCA						ba2	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.
[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.

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