FITCH AFFIRMS INVESTCORP'S RATINGS AT 'BB'; OUTLOOK REVISED TO STABLE

Fitch Ratings-Chicago-26 October 2018: Fitch Ratings has affirmed Investcorp Bank B.S.C.'s (Investcorp) Long-Term Issuer Default Rating (IDR) at 'BB' and its Viability Rating at 'bb'. The Rating Outlook has been revised to Stable from Positive. A full list of ratings is provided at the end of this release.

KEY RATING DRIVERS - VIABILITY RATING, IDRs, SUPPORT RATING, SUPPORT RATING FLOOR AND SENIOR UNSECURED DEBT

The Outlook revision reflects the limited observed progress on Investcorp's strategic partnership with Mubadala Development Co. (Mubadala), which acquired a 20% equity stake in the company in March 2017, an expectation that if this partnership were to gain momentum in the future, it would likely take some time to materialize, as well as the increasingly competitive alternative investment and credit environments, which could affect Investcorp's ability to originate/syndicate investments and/or the valuation of balance sheet co-investments. To a lesser extent, the Outlook revision also reflects economic and political pressure in Bahrain (downgraded to 'BB-'/Outlook Stable from 'BB+'/Outlook Negative on March 1, 2018) and the Middle East more broadly, which could affect Investcorp's investment placement/fundraising amongst Middle Eastern investors. Fitch notes that improving oil prices have, at least thus far, served as somewhat of a counterbalance to these dynamics in the region.

The rating affirmation reflects Investcorp's strong client franchise and high degree of brand name recognition in the Gulf, supported by its investment track record and long-term relationships in the region. The ratings also reflect Investcorp's adequate capitalization and leverage profile relative to the assigned ratings, with debt supported by both balance sheet investments and management fee generation capacity, and an appropriate funding strategy, which incorporates the use of long-dated debt to fund its co-investment portfolio, which reduces the impact of refinancing and liquidity risk inherent in Investcorp's business model of originating and syndicating alternative investments.

Rating constraints include increased potential earnings volatility and placement risk relative to peers, given that private equity and real estate transactions are primarily originated and placed with investors on a deal-by-deal (DBD) or pooled basis as opposed to dedicated funds with pre-determined investment periods and sizable balance sheet co-investment concentrations, which are subject to mark-to-market volatility. Fitch also notes potential execution risks associated with Investcorp's strategy to more than double assets under management (AUM), to $50 billion, over the medium term through both organic and inorganic growth.

While DBD placement activity remains a primary area of focus, Investcorp has begun to offer dedicated fund structures to appeal to certain institutional investors. Meaningful traction on this more traditional product offering would increase the scalability of the firm's business model and the stability of its management fees to the extent fees are based on committed capital fund structures, which would be viewed favorably by Fitch.

Investcorp enhanced its product diversification with the acquisition of the debt and CLO management business of 3i Group PLC (3i) in 2017 -- currently referred to as Investcorp Credit Management (ICM). This provides longer-term capital and increases earnings stability due to the recurring nature of management fees, although this is somewhat offset by the lower margins on the CLO business relative to Corporate Investments business. At June 30, 2018, ICM represented 51% of AUM and 55% of management fees.

AUM increased 5.7% in fiscal 2018, to $22.6 billion at fiscal-year-end June, 30 2018 (FYE18), driven by fundraising in private equity, real estate, alternative investment solutions (AIS) and credit, given capital raised for new CLOs and the refinancing of older CLOs. Aggregate inflows totaled $7.3 billion during FY18, which was partially offset by $6.3 billion of client realizations and redemptions.

Placement and fundraising activity for FY19 is expected to be driven by credit and AIS in the U.S. and Europe as well as DBD placements in private equity and real estate in the Gulf and Asia.

Investcorp's core operating performance, as measured by FEBITDA, which excludes investment income from co-investments and performance fees along with performance-related compensation, was up 3% to $33 million in FY18. The increase was largely driven by higher management fees from the credit business. The FEBITDA margin remained flat yoy at 34%. Fitch notes that a significant portion of Investcorp's fee-related earnings are based on activity fees earned from transactional activities, which can be volatile. Activity fees comprised 42.7% of core fees in FY18, down from 54% in FY17.

Investcorp's asset-based income, which reflects realized and unrealized gains and losses on co-investments, increased 27% in FY18 primarily reflecting a rebound in private equity returns from successful realizations during the year.

Performance fees totaled $20 million in FY18, which was flat relative to the prior year, reflecting stable performance of the underlying private equity portfolio.

Capital levels remained strong, with a reported Total Capital Ratio of 31.5% at FYE18, which is well in excess of the Central Bank of Bahrain's minimum requirement of 12.5%. Fitch views Investcorp's capital levels as appropriate given the balance sheet risk associated with its co-investment commitments to individual transactions.

Given the firm's meaningful balance sheet exposure, Fitch also assesses Investcorp's leverage on a debt to tangible equity basis. On this measure, Investcorp's leverage was 0.8x at June 30, 2018; down from 1.2x a year earlier, which is at the high end of Fitch's rated peer group and in line with quantitative leverage benchmark range for 'BB' rated alternative IMs.

At FYE18, the company remained within its targeted co-investment to long-term capital (long-term debt, deferred fees and total equity) ratio of 1.0x or lower, at a ratio of 0.7x, which Fitch views as appropriate. At FYE18, balance sheet co-investments increased 3.6% to $1.1 billion, with an increase in private equity and CLO retention exposure more than offsetting lower hedge fund co-investments.

Fitch believes Investcorp maintained adequate liquidity as of June 30, 2018 with $61 million of cash and short-term funds, $266 million of deposits with financial institutions and other liquid assets, along with $625 million of borrowing capacity on its corporate revolver. Liquidity resources are more than sufficient to address near-term debt maturities of $139 million in June 2019. Additionally, Investcorp had $1.2 billion of balance sheet co-investments at FYE18, which could serve as additional collateral for debt, although it is comprised of relatively illiquid investments.

Unfunded deal acquisitions and unfunded co-investment commitments to various private equity and real estate investment funds totaled $137 million at FYE18, which Fitch believes will be funded over time with cash on hand and operating cash flow. Fitch believes the company has significant discretion over the timing of these funding commitments.

Investcorp relies on a mix of secured and unsecured wholesale funding sources, supplemented with deposit funding, which are transitory balances including both subscription amounts paid in by clients toward participation in specific investment products and investment realization proceeds held in the interim period prior to distribution or withdrawal by clients.

Interest coverage, as measured by FEBITDA divided by interest expense, was 1.8x for FY18, which is weaker than the peer group average and within Fitch's quantitative benchmark range for 'B and below' category alternative IMs.

In August 2018, Mohammed Al-Shroogi retired from his position as co-CEO and was replaced by Hazem Ben-Gacem has become co-CEO alongside Rishi Kapoor. Mr. Ben-Gacem had been head of the firm's European private equity group since 2012. Also in August 2018, Investcorp appointed Jan Erik Back as CFO. Mr. Back previoulsy held several CFO roles including most recently at SEB (Skandinaviska Enskilda Banken AB), a Nordic financial services group.

Investcorp's 'BB' Long-Term IDR is equalized with its 'bb' Viability Rating based on Fitch's view of a limited likelihood of sovereign support. This is reflected in the Support Rating of '5' and the Support Rating Floor of 'No Floor'. The Support Rating of '5' and the Support Rating Floor of 'No Floor' reflect Fitch's view that there is no reasonable assumption that sovereign support will be forthcoming to Investcorp given the lack of a support track record and the fact that much of Investcorp's activities are conducted outside of Bahrain.

The affirmation of Investcorp's 'B' Short-Term IDR maintains the mapping relationship between long-term and short-term IDRs as outlined in Fitch's Global Bank Rating Criteria.

The senior unsecured debt rating is equalized with Investcorp's Long-Term IDR, reflecting the expectation for average recovery prospects for the debt class under a stress scenario.

RATING SENSITIVITIES - IDRs, VIABILITY RATINGS, AND SENIOR UNSECURED DEBT

Fitch believes rating upside is likely limited to the 'BB' rating category over the intermediate term due to the potential earnings volatility associated with the company's business model and balance sheet co-investment exposure. The company's DBD business model could be a profitability constraint in a period of investment origination and/or placement activity weakness, while elevated co-investment exposure introduces balance sheet risk in the event of investment losses. Post-origination placement may also introduce balance sheet risk in the event Investcorp is unable to place originated investments with clients.

Factors that could lead to an upgrade of Investcorp's ratings include prudent AUM growth, defined as growth that does not have a material impact on leverage or the balance sheet and can be easily scaled via Investcorp's existing infrastructure, enhanced AUM diversity, an increase in management fee contribution from committed capital fund structures and strengthened interest coverage, while maintaining adequate capitalization, co-investment funding and liquidity positions.

Negative rating actions could be driven by material declines in AUM in Investcorp's private equity, real estate or credit businesses; a material increase in balance sheet co-investments not funded by equity, higher leverage or a reduction in liquidity.

The senior unsecured debt rating is equalized with Investcorp's IDRs and therefore, would be expected to move in tandem. Although not envisioned by Fitch, were Investcorp to experience an increase in secured debt as a percentage of total debt, this could result in the unsecured debt rating being notched below Investcorp's Long-Term IDR.

SUPPORT RATING AND SUPPORT RATING FLOOR

Investcorp's Support Rating and Support Rating Floor are sensitive to changes in Fitch's assumptions regarding the likelihood of extraordinary sovereign support to be extended to Investcorp, which Fitch views as unlikely.

Fitch has affirmed the following ratings:

Investcorp Bank B.S.C.
--Long-Term IDR at 'BB';
--Short-Term IDR at 'B';
--Viability Rating at 'bb';
--Support Rating at '5';
--Support Rating Floor at 'NF'.

Investcorp S.A.
--Long-Term IDR at 'BB';
--Short-Term IDR at 'B';
--Senior unsecured debt at 'BB'.

Investcorp Capital Ltd.
--Long-Term IDR at 'BB';
--Short-Term IDR at 'B';
--Senior unsecured debt at 'BB'.

The Rating Outlook is Stable.

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Additional information is available on www.fitchratings.com

Applicable Criteria

Bank Rating Criteria (pub. 12 Oct 2018)

https://www.fitchratings.com/site/re/10044408

Non-Bank Financial Institutions Rating Criteria (pub. 12 Oct 2018)

https://www.fitchratings.com/site/re/10044407