

# **FITCH AFFIRMS INVESTCORP'S RATINGS AT 'BB'; OUTLOOK REVISED TO POSITIVE**

Fitch Ratings-Chicago-16 October 2019: Fitch Ratings has affirmed Investcorp Holdings B.S.C.'s (Investcorp) Long-Term Issuer Default Rating (IDR) and Short-Term IDR and its related entities (collectively Investcorp) at 'BB' and 'B', respectively. Concurrently, Fitch has withdrawn Investcorp's Viability Rating, Support Rating and Support Rating Floor given the relinquishment of the firm's banking license. The Rating Outlook has been revised to Positive from Stable. A full list of ratings is provided at the end of this release.

Today's rating actions have been taken as part of a periodic peer review of the alternative investment manager (IM) industry, which is comprised of seven publicly rated global firms. For more information on the broader sector review, please see, 'NRAC: Fitch Completes Alternative Investment Manager Peer Review', available at [www.fitchratings.com](http://www.fitchratings.com).

## **KEY RATING DRIVERS**

### **VIABILITY RATING, IDRs, SUPPORT RATING, SUPPORT RATING FLOOR AND SENIOR UNSECURED DEBT**

The Outlook revision reflects Investcorp's significant progress executing on its strategic initiatives, including continued AUM growth, institutionalizing its investor base, balance sheet de-risking and expanding its offering of committed capital fund structures, which is expected to increase the scalability of the firm's business model and the stability of its management fees. Fitch believes the completion of several strategic inorganic and organic initiatives will allow the firm to enhance its product offerings, expand growth in new markets and enhance fee-related earnings. However, there are execution risks associated with Investcorp's strategic growth initiatives, including integration risk associated with acquisitions and increased group complexity related to product and geographic expansion.

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 solid capitalization and leverage profile relative to the assigned ratings, strong profitability 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 on a deal-by-deal (DBD) basis.

Rating constraints include increased potential earnings volatility and placement risk associated with Investcorp's strategy of offering investments to its Gulf clients on an underwritten DBD basis and sizable, albeit reduced, balance sheet co-investments, which are subject to mark-to-market volatility. Further, the increasingly competitive alternative investment and credit environments could affect Investcorp's ability to originate/syndicate investments and/or reduce the valuation of balance sheet investments. Fitch believes economic and political pressure in the Middle East, including potential long-term supply issues in oil, could affect Investcorp's investment placement/fundraising amongst Middle Eastern investors. However, continued pressure in the region could motivate Gulf-based clients to increase global investments, demonstrated by record levels of capital being raised in the region by Investcorp in fiscal year (FY) 2019.

The acquisition and continued expansion of Investcorp Credit Management (ICM) has contributed significantly to recent AUM growth, the extension of capital duration and increased earnings stability due to the recurring nature of management fees, although this is somewhat offset by lower

margins on the CLO business relative to PE investments. While the acquisition enhanced product diversification, the size of the CLO business relative to Investcorp's other segments has created some concentration risk. ICM represented 42% of AUM at June 30, 2019 and 28% of management fees in FY19.

While ICM is principally CLO-centric, the firm aims to build out the non-CLO side of its credit business over time. In June 2019, Investcorp announced its entry into the direct lending space with the acquisition of a majority stake in CM Investment Partners (CMIP), the investment advisor to CM Finance, a publicly traded business development company (BDC). CMIP had approximately \$330 million in AUM at June 30, 2019. The transaction expands Investcorp's investor base, given the BDC's large institutional backing. While the addition of credit products will support growth in management fees, the expansion occurs at a time when underwriting conditions are exceptionally competitive. Fitch will evaluate the performance of the BDC over time.

In May 2019, Investcorp also announced plans to acquire placement agent Mercury Capital Advisors, which has relationships with over 2,500 institutional investors across the globe. Mercury is expected to remain an independent business operating under its current leadership team. The transaction is expected to close in the fourth quarter of 2019. Mercury is expected to further strengthen Investcorp's capital raising efforts.

Investcorp's strategic investment in an independent, Swiss-regulated private bank provides a platform for Investcorp to offer investment solutions to high-net-worth individuals, family offices and institutional clients primarily from Switzerland and Europe, which should help drive AUM growth. Investcorp successfully completed a fundraising collaboration with private clients during FY19. The bank will remain operationally independent.

AUM increased 7.1% annually, to \$28.2 billion, at fiscal year end June, 30 2019, primarily driven by solid fundraising in private equity, credit and absolute return investments (ARI). Net client flows averaged 2.7% of beginning AUM over the past four years, excluding M&A transactions. In FY19, aggregate inflows totaled \$5.7 billion, up from \$3.5 billion in the prior year, which was partially offset by \$3.7 billion of client realizations and redemptions. Fundraising activity for FY20 is expected to be solid across the platform assuming markets remain accommodative.

Fitch views Investcorp's core operating performance as incrementally improved, due to the relative stability of management fees derived from the credit business. Core fee revenues were up 14% in FY19, driven by significantly higher activity fees, which are earned from transactional activities and tend to be somewhat volatile, and modest growth in management fees, driven by continued expansion in AUM. Activity fees represented almost half of core fees in FY19. Fitch would view reduced reliance on activity fees favorably.

Core operating performance, as measured by fee-related EBITDA (FEBITDA), which excludes investment income from co-investments, performance fees and performance-related compensation was up 39.6% in FY19, YoY, largely driven by higher activity fees. The firm's FEBITDA margin expanded to 45.1% in FY19, compared to 36.5% in the prior year. Margins could be adversely affected in a market downturn, given the relative contribution from activity fees, which are largely market-driven.

Asset-based income, which reflects realized and unrealized gains and losses on co-investments, was \$89 million in FY19, down from \$133 million in FY18. The decline primarily reflects lower returns on PE investments, due to currency devaluation in the Turkish lira, valuation declines in certain U.S. retail sector exposures and the write-down of legacy assets.

Realized performance fees were up 40% in FY19 but tend to be lumpy from period to period due to deal activity and market volatility.

In an effort to de-risk its balance sheet, Investcorp completed several secondary transactions in 2019, which contributed to a 12.5% reduction in its co-investment portfolio at FYE19, YoY. In addition, the announced sale of its largest balance sheet holding, TelePacific Holdings Corp., post-FYE will reduce the co-investment portfolio by an additional 7.5%, notwithstanding continued working capital support provided to the company. A portion of Investcorp's secondary transactions raised almost \$1 billion of third party capital and contributed to AUM growth in committed capital structures.

Investcorp's leverage, as measured by long-term debt to FEBITDA, amounted to 3.0x for the TTM ended June 30, 2019, which represents a significant reduction from the prior year, at 6.7x, due to the repayment of debt, 100% equity treatment afforded to preference shares and FEBITDA growth. Leverage is in line with Fitch's 'bbb' category quantitative benchmark range of 2.5x to 4x for alternative IMs.

Given its significant balance sheet usage, Fitch also assesses Investcorp's leverage on a debt to tangible equity basis. On this measure, Investcorp's leverage was 0.5x at June 30, 2019; down from 0.8x a year earlier, which is relatively low and in-line with the peer group.

Fitch views Investcorp's funding profile favorably, with unsecured debt representing 82% of total debt. The firm also has \$123 million of preference shares, which are noncumulative and perpetual in nature and, thus receive 100% equity treatment in accordance with Fitch's 'Corporates Hybrids and Notching Criteria' dated November 2018. Investcorp also holds client deposits, which are transitory balances and include 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. Fitch expects these deposits to remain in place despite the firm no longer being regulated as a bank.

Fitch believes Investcorp maintained adequate liquidity at June 30, 2019, with \$57 million of cash and short-term funds, \$333 million of deposits with financial institutions and other liquid assets, along with \$686 million of borrowing capacity on its corporate revolvers. Additionally, Investcorp had \$1.0 billion of balance sheet co-investments at FYE19, which could serve as additional collateral for debt, although it is comprised of relatively illiquid investments. The firm has no near-term debt maturities.

Unfunded deal acquisitions and unfunded co-investment commitments to various PE and RE investments totaled \$77 million at FYE19, 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.

Interest coverage, as measured by FEBITDA divided by interest expense on corporate debt, was 3.8x for FY19, which was within Fitch's quantitative benchmark range of 2x-4x for alternative IMs in the 'bb' rating category. Fitch recognizes that coverage ratios would look meaningfully better if asset-based income on co-investments were included in FEBITDA.

In September 2019, Investcorp completed the realignment of its operational structure in Bahrain along with the conversion of the parent company from a wholesale bank to a holding company. Investcorp Bank B.S.C. voluntarily surrendered its Bahrain-based wholesale bank license and was renamed Investcorp Holdings B.S.C. With the approval of shareholders and the Central Bank of Bahrain (CBB), the company incorporated a category 1 investment business firm in Bahrain called Investcorp Financial Services B.S.C. (IFS), and after engaging with clients, strategic partners and other stakeholders, completed the process of transitioning its regulated marketing, placement and MENA PE investment advisory and asset management services to IFS.

Fitch views Investcorp's relinquishment of its banking license as neutral to its ratings. The incrementally negative impact from having less regulatory oversight is sufficiently offset by the expectation that capital will be maintained at or near currently robust levels and that liquidity and operational risk management frameworks will remain unchanged.

Given the relinquishment of its banking license, Fitch has withdrawn Investcorp's 'bb' Viability Rating, the Support Rating of '5' and the Support Rating Floor of 'No Floor'.

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 Short-Term 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 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 fee-paying AUM growth, enhanced scalability of the platform and 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 without meaningful growth in balance sheet co-investments.

Negative rating actions could be driven by material declines in AUM, which impairs the firm's management fee generating capacity; 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.

#### ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3 - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity.

For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

Fitch has affirmed the following ratings:

Investcorp Holdings B.S.C.

--Long-Term IDR at 'BB';

--Short-Term IDR at 'B'.

Investcorp S.A.

--Long-Term IDR at 'BB';

--Short-Term IDR at 'B'.

Investcorp Capital Ltd.

--Long-Term IDR at 'BB';

--Short-Term IDR at 'B';

--Senior unsecured debt at 'BB'.

Fitch has withdrawn the following ratings:

Investcorp Bank B.S.C.

--Viability Rating at 'bb';

--Support Rating at '5';

--Support Rating Floor at 'NF'.

The Rating Outlook was revised to Positive from Stable.

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Applicable Criteria

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

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

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