FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Investcorp's Ratings at 'BB'; Outlook Revised to Stable

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Fitch Ratings - Chicago - 03 Apr 2020: Fitch Ratings has affirmed the Long-Term Issuer Default Rating (IDR) and Short-Term IDR of Investcorp Holdings B.S.C. and its related entities (collectively Investcorp) at 'BB' and 'B', respectively. The Rating Outlook has been revised to Stable from Positive.

KEY RATING DRIVERS

IDR AND SENIOR UNSECURED DEBT

The Outlook revision reflects Fitch's view of the impact the global coronavirus pandemic will have on Investcorp's ability to execute on its strategic initiatives over the next 12-18 months, including continued growth in assets under management (AUM), the institutionalization of its investor base and the ability to expand committed capital fund structures. While Fitch believes there is upside potential to Investcorp's ratings over time, it will likely be pushed out beyond Fitch's outlook horizon.

Investcorp's business model of offering investments to its clients on a fully underwritten deal-by-deal (DBD) basis and maintaining a sizable co-investment portfolio, which is subject to fair value changes, increases the firm's earnings volatility and placement risk, making it particularly susceptible to a market downturn, relative to the peer group. Fitch also believes activity fees, which are earned from transactional activities and have comprised almost half of Investcorp's core fees over the past three years, will be under pressure in the near to intermediate term.

While the impact of oil price volatility on Investcorp's portfolio companies is limited, depressed oil prices will likely have fiscal impacts in the region. Still, Investcorp's Gulf investors have demonstrated relatively low sensitivity to oil price movements, as evidenced by record levels of DBD placement activity during previous periods of volatility in the energy sector. While Fitch believes Gulf investors will continue to explore opportunities to diversify outside the region, potential liquidity challenges could disrupt efforts in the near term.

The rating affirmation reflects Fitch's view that recent steps taken by Investcorp to de-risk its balance sheet and shore up liquidity will allow the firm to withstand an economic downturn. The ratings also reflect the locked-in nature of most of Investcorp's fee streams, its 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.

Over the past year, Investcorp has taken several steps to reduce balance sheet risk, including the sale of investments through two secondary transactions with HarbourVest Partners and Coller Capital and the sale of TPx Communications in February 2020, which represented the largest co-investment exposure on its balance sheet at approximately 11% at Dec. 31, 2019. Co-investments totaled $1.1 billion at Dec. 31, 2019.

AUM totaled $31.1 billion at Dec. 31, 2019, up 10.7% from fiscal YE 2019 (June 30, 2019), as fundraising and placement activity outpaced realizations during the year. Net client flows averaged 3.8% of beginning AUM over the past four years, excluding M&A transactions. Aggregate inflows totaled $2.6 billion in 1H20, up $300 million from 1H19. Fitch believes fundraising activity for 2H20 will be more uncertain, given the impact the coronavirus is having on travel and market activity.

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 28.5% for TTM Dec. 31, 2019, largely driven by higher activity fees. FEBITDA margin was 48.0% in 1H20, on a TTM basis, compared with 42.4% in the prior-year period. Fitch believes margins will be adversely affected in the near to intermediate term, given the relative contribution from activity fees, which are largely market driven.

Asset-based income, which reflects gains and losses on co-investments, was down 71% in 1H20, reflecting lower returns on private equity (PE) investments due to valuation declines in certain U.S. retail sector exposures and a writedown on its investment in IT services provider TPx. Realized net performance fees, which tend to be lumpy from period to period due to deal activity and market volatility, were $3 million in 1H20, compared with $9 million the prior year.

Investcorp's leverage, as measured by debt to tangible equity, amounted to 0.9x at Dec. 31, 2019, up from 0.4x at fiscal YE 2019. The increase reflects Investcorp's transition to a holding company and the transfer of what were client bank deposits (which were excluded from prior leverage calculations) into a client trust, which has subsequently extended a $452 million revolving loan facility to the company. Debt to FEBITDA was 5.6x for the TTM ended Dec. 31, 2019, up from 2.5x at fiscal YE 2019 given draws on the revolving loan facility. On a hybrid basis, leverage is in line with Fitch's 'bbb' category quantitative benchmark range for alternative investment managers.

Cash and short-term assets totaled $281 million, compared with $984 million of debt outstanding at Dec. 31, 2019. In March 2020, the company upsized borrowing capacity on its corporate revolver, which currently stands at $786 million, and extended the maturity, with a portion maturing in 2023 and the remainder in 2024. Since YE 2019, Investcorp has taken steps to boost its liquidity, such as proactively drawing on corporate revolvers and further boosting its cash position, which is now sufficient to cover short-term debt balances.

Fitch believes the extension of credit offered by Investcorp's clients provides flexibility to the firm to execute on investment opportunities, although the withdrawal of client assets would reduce the firm's liquidity. Still, Investcorp has long-standing client relationships that have proven to be sticky throughout various market cycles.

Unfunded deal acquisitions and unfunded co-investment commitments to various PE and real estate investments totaled $224 million at Dec. 31, 2019, 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. Fitch believes additional liquidity demands could include shoring up capital for PE portfolio companies.

The senior unsecured debt rating is equalized with Investcorp's Long-Term IDR, reflecting the largely unsecured funding profile, expectations for average recovery prospects under a stress scenario and joint and several guarantees by Investcorp S.A., which is the principal operating and asset owning arm of the firm.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

--Fee-paying AUM growth;

--Enhanced scalability of the platform and AUM diversity;

--Institutionalizing the investor base;

--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.

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, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

--Material declines in AUM, which impair 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 would therefore 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.

BEST/WORST CASE RATING SCENARIO

Best/Worst Case Rating Scenarios - Financial Institutions:

Ratings of Financial Institutions issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

ESG issues are credit neutral or have only a minimal credit impact on the entity(ies), either due to their nature or the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		
Investcorp Capital Ltd.	LT IDR	BB	Affirmed
	ST IDR	B	Affirmed
• senior unsecured	LT	BB	Affirmed
Investcorp S.A.	LT IDR	BB	Affirmed
	ST IDR	B	Affirmed
Investcorp Holdings	LT IDR	BB	Affirmed

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Non-Bank Financial Institutions Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Investcorp Capital Ltd.	EU Endorsed
Investcorp Holdings B.S.C.	EU Endorsed
Investcorp S.A.	EU Endorsed

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